No. 92-267

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

October Term, 1992

UJB FINANCIAL CORP., et al.,

Petitioners,

against

IRWIN SHAPIRO, ROBERT BASSMAN, JEROME KATZ, NORMAN SALSITZ, JEAN LEE, and CHAPPAQUA FAMILY TRUST,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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August 12, 1992

QUESTIONS PRESENTED FOR REVIEW

1. Did the Third Circuit err in announcing a new, "relaxed" application of Rule 9(b), Fed. R. Civ. P., which

    - flatly conflicts with the standards of the First, Second and Seventh Circuits, as well as the standard previously established by the Third Circuit (including as applied by a different panel of the Third Circuit on the same day); and

    - is so "relaxed" that, in effect, it eviscerates Rule 9(b)'s express, heightened pleading requirement and equates it with Rule 8's "notice pleading" standard?

2. Is any statement made by management "addressing the quality of a particular management practice" material merely by virtue of addressing same, as the Third Circuit stated, despite this Court's contrary determination in *Basic Inc. v. Levinson*, 485 U.S. 224, 240 (1988) (not cited by the Third Circuit) that "materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information"?

RULE 29.1 STATEMENT

The parties to the proceedings below were the petitioners, UJB Financial Corp., T. Joseph Semrod, Clifford H. Coyman, John R. Haggerty, Robert L. Boyle, Elinor J. Ferdon, Walter L. Dealtrey, Fred G. Harvey, Francis J. Mertz, Henry S. Patterson II, James A. Skidmore, Jr. and Joseph M. Tabak and the respondents Irwin Shapiro, Robert Bassman, Jerome Katz, Norman Salsitz, Jean Lee, and Chappaqua Family Trust.

UJB Financial Corp. has no subsidiaries (except wholly-owned subsidiaries) or affiliates as those terms are used in Supreme Court Rule 29.1.

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OPINIONS BELOW

The opinion of the United States Court of Appeals for the Third Circuit is reported at 964 F.2d 272 (3d Cir. 1992). The Third Circuit's slip opinion dated May 20, 1992 is reproduced at Appendix I A-1-35. The Third Circuit's denial of defendants' request for rehearing or rehearing in banc dated July 7, 1992 is reproduced at Appendix I A-51-52. The transcript opinion of the United States District Court for the District of New Jersey (Thompson, J.) dismissing, in part, the Complaint is reproduced at Appendix I A 38-50.

JURISDICTION OF THIS COURT

The judgment of the Court of Appeals was entered and filed on May 20, 1992 and rehearing was denied by the Court of Appeals on July 7, 1992. The judgment may be reviewed by this Court by writ of certiorari granted under 28 U.S.C. § 1254(1) (1988). This petition for a writ of certiorari to review the judgment of the Court of Appeals, having been filed within 90 days after the entry of the judgment and denial of rehearing, is timely under 28 U.S.C. § 2101 (c) and Supreme Court Rule 13.

STATUTE AT ISSUE

- Rule 9(b), Federal Rules of Civil Procedure:

> **Fraud, Mistake, Condition of the Mind.** In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally.

STATEMENT OF THE CASE

A. Nature of the Case

This action (one of dozens which have been filed against banks in the Northeast in the past three years) arises out of the fact that the price of UJB Financial Corp.'s ("UJB") stock—like that of so many banks—declined substantially as the country slid into a recession. As a result of the recession, UJB, like other banks, faced increases in borrower defaults and declines in the value of collateral securing bank loans in the period immediately predating the Complaint.[1] The Complaint is premised upon plaintiffs' conclusory allegations (pleaded entirely on information and belief) that supposedly, UJB and eleven of its directors, including eight outside directors who were members of its audit committee, deliberately overstated the adequacy of UJB's lending practices and provided inadequate reserves for loan losses in the pre-recession period. Plaintiffs' claims are based on nothing more than the effect which the severe economic downturn, particularly in the Northeast, had on the financial condition of UJB, as well as so many other lenders.

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1. *See, e.g.*, Barbara Franklin, *The Recession's Upside*, N.Y.L.J., Feb. 14, 1991, at 5 (reporting that "[m]any" suits "target . . . banks for allegedly understating information on bad loans," and noting one lawyer's observation that "[e]veryone who has announced increases in loan loss reserves has been sued"); Doug Bailey, *Law Suits A Way Of Life For Banks*, Boston Globe, July 5, 1990, at 57 (reporting that "[s]ince last year, when the fortunes of all of the region's banks began [sic] to sag, shareholders and their attorneys have pounced, filing a slew of class action lawsuits charging that the banks should have foreseen, and publicly warned about, the tough times ahead," and observing that "the same group of lawyers have [sic] brought virtually all the suits, which use the same 'boilerplate' language, from the same master form"). Indeed, over 50 such "cookie cutter" complaints were filed against banks other than UJB in 1990 alone. *See, e.g.*, *FDIC Says Real Estate Slump In Area, Northeast Is Weakening U.S. Banks*, The Washington Post, Sept. 7, 1990, at A1; *Financial Loss: Big Banks Are Plagued by a Gradual Erosion of Key Profit Centers*, Wall St. J., Aug. 1, 1990, at 1 col. 6; *Real Estate Crisis Takes Toll of U.S. Banks*, Financial Times, May 11, 1990, at 33.

Plaintiffs' contentions (which defendants vigorously deny) reflect a classic example of the long-condemned practice of alleging fraud by "20-20 hindsight." Plaintiffs have seized on UJB's public announcements in 1990 that it had increased its loan loss reserves and had written off certain loans in whole or in part—which one would consider quite prudent and appropriate under the circumstances of a declining economy—as a basis for alleging that the level of loan loss reserves established in prior periods (1987-89) were fraudulently understated and that UJB's statements in that pre-recession period as to the propriety and prudence of its lending policies were false. Ignoring the well-publicized change in the economic climate between the earlier and later periods—and that loans that were prudent and well-secured when made may have to be written down, and reserves for possible losses increased, if a recession later occurs and borrowers' businesses are adversely affected and the value of the lender's collateral (such as real estate in the Northeast) plummets—plaintiffs contend in purely conclusory terms, and without pleading any facts, that the earlier disclosures were false.

Plaintiffs have not identified, in the 1987-89 period in issue, a single UJB loan or category of loans that was under-reserved, a single method or standard by which reserves should have been, but supposedly were not set, a single loan that UJB improperly failed to write-off, a single lending practice that was inappropriate, or a single fact demonstrating that any defendant (eight of whom are outside directors) at any time acted with scienter. Plaintiffs are unable to do so because they have no facts that support their allegations of fraud. Indeed, when the district court offered them the opportunity to replead— which would have been easy enough to do if they had any facts to support their glib charges of fraud—plaintiffs declined to do so. Rather, plaintiffs appealed; the Third Circuit reversed the District Court and announced a new standard of pleading fraud pursuant to Rule 9(b), Fed. R. Civ. P. As discussed below, such standard conflicts with the standards established by other Courts of Appeals and by the Third Circuit itself in prior caselaw. In addition, the Third Circuit stated that "[b]y addressing the quality of a particular manage-

ment practice, a defendant declares the subject of its representation to be material." *UJB*, 964 F.2d at 282 (A-18). This statement directly conflicts with this Court's decision in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), which held to the contrary.

B. The Course of Proceedings

This action commenced with the filing of three separate complaints in April and May of 1990. These separate actions were consolidated with the filing of a single pleading (the "Complaint") on September 4, 1990. The district court's jurisdiction was based upon Section 22 of the Securities Act of 1933 ("Securities Act"), Section 27 of the Securities Exchange Act of 1934 ("Exchange Act") and upon 28 U.S.C. § 1332 (diversity jurisdiction). Despite filing four separate complaints, plaintiffs still have not alleged a single fact demonstrating or raising even a fair inference that the defendants made any misstatements, much less fraudulent ones.

The Complaint contained both class and derivative allegations and charged the defendants, a bank holding company and eleven of its directors, with violations of Sections 11, 12 and 15 of the Securities Act, Sections 10(b), 14(a) and 20 of the Exchange Act, rules of the Securities and Exchange Commission ("SEC") promulgated pursuant thereto, negligent misrepresentation, breach of fiduciary duty and waste of corporate assets. All such claims were based upon defendant UJB's supposedly deliberate reporting of inadequate loan loss reserves and alleged overly optimistic or inaccurate statements as to the prudence of its lending operations and its internal management and credit controls. Defendants moved to dismiss all claims pursuant to Rules 12(b)(6) and 9(b), Fed. R. Civ. P.

The district court's well-reasoned and well-supported decision on the motion to dismiss is set forth in its Opinion, dated January 22, 1991 (annexed as Appendix ("A") I hereto, at A-38). (On February 15, 1991, the district court issued its Order embodying its decision). After parsing out and carefully analyzing plaintiffs' allegations, the court dismissed, without leave to amend, pursuant to Rule 12(b)(6), certain portions of plaintiffs' claims under Section

10(b) of the Exchange Act and Sections 11 and 12(2) of the Securities Act as sounding in mismanagement, not actionable under the federal securities laws (A-43). It denied the motion under Rule 12(b)(6) as to the claims under Sections 14(a) and 20.

With respect to so much of the misrepresentation and omission claims under Sections 10(b), 11 and 12(2) as were not dismissed pursuant to Rule 12(b)(6), the district court properly found that such claims did not satisfy the pleading requirements of Rule 9(b), but it did not dismiss those claims. Instead, the district court granted plaintiffs leave to replead, and ordered that if plaintiffs did not replead, the court would entertain a renewed motion to dismiss (A-50). In applying Rule 9(b) to the allegations of this Complaint, the district court followed the Third Circuit's earlier decisions in *Christidis v. First Pennsylvania Mortgage Co.*, 717 F. 2d 961 (3d Cir. 1983), and *In re Craftmatic Securities Litigation v. Kraftsow*, 890 F.2d 628 (3d Cir. 1989) (as well as decisions of the Second Circuit in *Denny v. Barber*, 576 F.2d 465 (2d Cir. 1978), and the Seventh Circuit in *DiLeo v. Ernst & Young*, 901 F.2d 624 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990)). The district court found that while plaintiffs had alleged the "who, what and where" elements of a fraud claim with sufficient particularity, the plaintiffs utterly failed to indicate "how" the statements allegedly were misleading (A-49).[2]

The Third Circuit affirmed in part and reversed in part the district court's decision (964 F.2d 272 (3d Cir. 1992), reprinted at A-1 herein). In the portion of the opinion which is the subject of this petition, the Third Circuit reversed the district court's decision to the extent it held portions of the Complaint insufficient under Rule 9(b), and it announced a new, "relaxed" standard (id. at 285 (A-24))

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2. The district court also dismissed pursuant to Rule 12(b)(6), plaintiffs' Section 11 and 12(2) claims for failure to plead all the elements of those claims. The negligent misrepresentation claim and purported derivative claims also were dismissed. (A-48).

for pleading fraud under Rule 9(b).[3] The pleading standard announced by the Third Circuit is in conflict with the pleading standard in the First, Second and Seventh Circuits, the Third Circuit's own earlier decisions, and the decision of another panel of the Third Circuit decided the same day as the instant case, which affirmed the dismissal of a virtually identical complaint. *See Decker v. Landmark Sav. Ass'n*, No. 91-3776 (3d Cir. May 20, 1992) (reprinted, along with other decisions which are not reported officially or available on Westlaw, in Appendix II, hereto, at AII-6); *Romani v. Shearson Lehman Hutton*, 929 F.2d 875 (1st Cir. 1991); *DiLeo v. Ernst & Young*, 901 F.2d 624 (7th Cir. 1990); *Denny v. Barber*, 576 F.2d 465 (2d Cir. 1978). The Third Circuit held that, under its new standard, all that is necessary to satisfy the requirements of Rule 9(b) is a statement that the facts needed to plead the alleged fraud with particularity lie solely within defendants' control and a delineation of "the nature and scope of plaintiffs' efforts to obtain, before filing the complaint, the information needed to plead with particularity." *UJB*, 964 F.2d at 285 (A-24). In view of its newly announced pleading standard, the Third Circuit afforded plaintiffs yet another opportunity to replead the claims which plaintiffs already had expressly declined to replead. *Id.*

In reaching its decision to reverse the district court's dismissal of certain of plaintiffs' allegations as merely reflecting mismanagement, and not material misstatements, the Third Circuit further stated that simply by commenting

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3. The Third Circuit, elsewhere in its opinion, agreed with the district court that certain of the allegations did not state a claim under the federal securities laws since they constituted mere puffing, failure to predict the future, or mismanagement (A-20-22). The Third Circuit reversed the district court's dismissal pursuant to Rule 12(b)(6) of certain other portions of the Complaint (finding that such portions did allege misrepresentations rather than merely mismanagement). It also reversed the dismissal pursuant to Rule 12(b)(6) of the Section 11 and 12(2) and negligent misrepresentation claims (A-25-35). The Section 14(a) claim was withdrawn with prejudice by plaintiff Chappaqua, subsequent to the filing of the appeal to the Third Circuit, in an effort to create a final decision subject to appellate jurisdiction.

on its operating or lending practices (e.g., by characterizing them as "prudent" or "conservative"), UJB "declares the subject of its representation to be material." *Id.* at 282 (A-18). The Third Circuit's statement on materiality in this regard (a point neither argued nor briefed to that court or to the district court) totally ignored the directly contrary holding of this Court in *Basic Inc. v. Levinson*, 485 U.S. 224, 240 (1988).

The Third Circuit denied defendants' request for rehearing or rehearing in banc on July 7, 1992, but stayed the issuance of the mandate to allow defendants an opportunity to petition this Court for a writ of certiorari. The Third Circuit's decision has created an inter-circuit conflict (Point IA.), and an intra-circuit conflict (Point IB.) with regard to the requirements of Rule 9(b), and ignores the controlling authority of this Court (Point II) governing materiality of public statements; thus, certiorari should be granted to permit this Court to address two critical issues that arise in virtually every action alleging fraud in securities actions in federal court.

REASONS FOR GRANTING THE WRIT

I. THE DECISION OF THE THIRD CIRCUIT EVISCERATES THE REQUIREMENTS OF RULE 9(b), CREATES AN INTOLERABLE CONFLICT AMONG THE CIRCUITS, AND PERPETUATES THE EXISTING STATE OF CONFUSION AT THE DISTRICT COURT LEVEL

This petition brings to the Court a case on which to resolve a most significant procedural issue: the standard of pleading under Rule 9(b), which applies to every fraud case filed in every federal court and is implicated in literally hundreds of securities cases every year, including every action under Section 10(b) of the Exchange Act and SEC Rule 10b-5 (17 C.F.R. § 240.10b-5 (1992)) promulgated thereunder. The Third Circuit's decision in *UJB* announces a new, "relaxed" standard under Rule 9(b). This standard flatly conflicts with the pleading standards of the First, Second and Seventh Circuits, relaxes the Third Circuit's prior standard, and is inconsistent with the decision of another panel of the Third Circuit which affirmed the dis-

missal of a virtually identical complaint on the very same day. *See infra*, pages 20-23. Moreover, Rule 9(b) specifically imposes more stringent standards than Rule 8 "notice pleading" upon a plaintiff who wishes to assert fraud. The "relaxed" standard announced by the Third Circuit in *UJB* thus frustrates the express terms of Rule 9(b), as well as the important policies underlying that Rule, including: precluding strike suits by ensuring that a plaintiff has investigated and obtained the facts supporting fraud charges *before* filing suit; placing defendants on notice of the precise wrongdoing with which they are charged; and protecting the reputations of defendants from the harm which results from the mere pendency of a fraud action (*see infra*, pages 23-25).

This Court should grant petitioners' request for a writ of certiorari to address the conflict among the Circuits, within the Third Circuit itself, and the resulting confusion and inconsistency among the district courts. Review is particularly appropriate where, as here, the conflict involves interpretation of a provision of the Federal Rules of Civil Procedure which this Court has never addressed. *See*, *e.g.*, *Hanna v. Plumer*, 380 U.S. 460, 463 (1965) (granting certiorari "[b]ecause of the threat to the goal of uniformity of federal procedure posed by the decision below"); *Schlagenhauf v. Holder*, 379 U.S. 104, 112 (1964) (granting certiorari on issue concerning Federal Rule 35(a), finding it appropriate "to formulate the necessary guidelines in this area"); *Hickman v. Taylor*, 329 U.S. 495, 500 (1947) (granting certiorari to interpret Federal Rules 26 to 37 where there had existed "a great divergence of views among district courts").

The Third Circuit's newly-pronounced pleading standard under Rule 9(b) permits a plaintiff to prosecute a securities fraud action, despite plaintiff's inability to plead any facts demonstrating how any defendant's behavior departed from proper conduct, or how any defendant's statement was inaccurate (much less fraudulent), solely on the ground that such plaintiff claims to have been unable to uncover any such facts prior to the filing of a complaint. Such standard eviscerates Rule 9(b)'s requirement that fraud be pled with particularity. The Third Circuit's standard also subjects

defendants both to lengthy and costly pretrial discovery—particularly in actions such as this one, challenging a multi-billion dollar bank's lending and credit-monitoring practices and policies in its entire loan portfolio over a four-year period—which simply may confirm the absence of any such facts, and to subsequent summary judgment motion practice, rather than permitting dismissal at the pleading stage. Such a standard thus is irreconcilably in conflict not only with Rule 1, Fed. R. Civ. P. which states that the Federal Rules of Civil Procedure "shall be construed to secure the just, speedy, and inexpensive determination of every action," but also with the decisions of other circuits (and with other panel decisions of the Third Circuit) which have required that a plaintiff asserting a securities fraud claim must plead facts demonstrating *how* the alleged conduct was wrongful, even under a "relaxed" standard.

The inter-circuit conflict, discussed in Point IA.1. below, is crystal-clear. As the Seventh Circuit held in *DiLeo*, in affirming dismissal of a complaint which challenged certain financial statements as false based solely on subsequent financial statements which disclosed less favorable operations and earnings in later periods, "[b]ecause only a fraction of financial deteriorations reflects fraud, plaintiffs may not proffer the different financial statements and rest. Investors must point to some facts suggesting that the difference is attributable to fraud." 901 F.2d at 627. The First Circuit likewise has noted that absent a standard under Rule 9(b) requiring the pleading of facts showing how or why prior financial statements were false, "the advent of a recession could be expected to trigger a multitude of complaints in which plaintiffs seek to impose liability for their financial disappointments based on entirely fabricated scenarios of fraud." *Romani*, 929 F.2d at 880. The Third Circuit's decision in *UJB* is contrary to the well-reasoned decisions of these courts, for it allows plaintiffs to "simply seize[ ] upon disclosures made in later annual reports and allege[ ] that they should have been made in earlier ones" (*Denny*, 576 F.2d at 470), a practice expressly rejected by the Second and Seventh Circuits in *Denny* and *DiLeo*.

The irreconcilable inter-circuit conflict without more,

makes this case eminently worthy of certiorari. As discussed in Point IA.2. below, however, the disarray among the district courts on the standard to be applied under Rule 9(b) adds an additional reason for this Court to grant certiorari. As illustrated below, the lack of uniformity among the federal district courts—even those within the same circuit or district—is compelling. For example,

- *Compare Hershfang v. Citicorp*, 767 F. Supp. 1251, 1257 (S.D.N.Y.), *reh'g denied*, No. 90 Civ. 8178 (MBM), 1991 U.S. Dist. LEXIS 13881 (S.D.N.Y. Oct. 1, 1991) (Rule 9(b) requires that facts be alleged that would generate an inference of guilty knowledge, and a bank's "sudden about-face announcement" is not sufficient to support inference of fraud) *with In re Chase Manhattan Corp. Sec. Lit.*, No. 90 Civ. 6092, slip op. at 4 (LMM) (S.D.N.Y. Aug. 1, 1991) (Rule 9(b) only requires that plaintiffs identify who made the alleged misstatements, when they were made and their contents).
- *Compare Fox v. Equimark Corp.*, 782 F. Supp. 295, 300 (W.D. Pa. 1991) (under Rule 9(b), plaintiff must allege facts suggesting how financial reverses were fraudulent; failure to "specify *how* Equimark knew the reserves to be inadequate or *why* it should have increased its reserves earlier" resulted in dismissal) *with Urbach v. Sayles*, 779 F. Supp. 351 (D.N.J. 1991) (holding that Rule 9(b) only requires allegations identifying the statements which plaintiff contends were fraudulent when made—relying on *In re Midlantic Corp. Shareholder Litig.*, 758 F. Supp. 226 (D.N.J. 1990), an opinion which the *Fox* court expressly declined to follow).
- *Compare Save-on-Surplus Pension Plan v. United Saver's Bancorp, Inc.*, 760 F. Supp. 971, 975 (D.N.H. 1990) (Devine, Ch.J.) (complaint satisfies Rule 9(b) by making extensive references to the statements alleged

to be false or misleading), *with* the same Court's subsequent decision in *Shields v. Amoskeag Bank Shares, Inc.*, 766 F. Supp. 32, 38 (D.N.H. 1991) (Devine, Ch.J.) (noting the "flood of securities fraud class action suits" filed recently, declining to follow *Save-On*, and deciding to adopt "the wisdom of the majority" of courts, which hold that Rule 9(b) requires that plaintiffs allege how statements were fraudulent when made).

As noted in Point B, even the decisions of the Third Circuit itself applying and interpreting Rule 9(b) are inconsistent.

A. Review Of The Third Circuit's Decision Is Compelled By The Conflicts That Exist Among The Circuits And The Resulting Lack Of Uniformity Among District Courts

1. Circuit Court Conflicts In Applying Rule 9(b)

Rule 9(b) provides: "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." The Courts of Appeals for the First, Second and Seventh Circuits have construed this particularity standard to require the identification of who, what, where, when *and how* the alleged misstatement was fraudulent. *See Romani*, 929 F.2d at 878; *Denny*, 576 F.2d at 470; *DiLeo*, 901 F.2d at 627.[4] These circuits have

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4. Numerous district courts have followed the sound reasoning of those decisions. *See, e.g.*, in addition to *Fox, Hershfang* and *Shields*, *supra* p.10-11, *Ciresi v. Citicorp.*, 782 F. Supp. 819, 821 (S.D.N.Y. 1991), *aff'd mem.*, 956 F.2d 1161 (2d Cir. 1992); *Shields v. Washington Bancorporation*, No. 90-1101, 1992 WL 88004 at *6 (D.D.C. Apr. 7, 1992) (dismissing allegations that annual report "'falsely portrayed [the bank] as a sound, growing and responsible lender'"); *Driscoll v. Landmark Bank for Sav.*, 758 F. Supp. 48, 53 (D. Mass. 1991) ("If this complaint is sufficient, any plaintiff could file a suit against any New England bank that has experienced losses as a result of this period of recent economic turndown"), *amended complaint dismissed*, C.A. No. 90-11593-C, 1992 U.S. Dist. LEXIS 1718 (D. Mass.

(continued...)

stressed that without pleading such facts, a complaint contains only "fraud by hindsight" allegations which cannot satisfy Rule 9(b). In *Denny*, for example, a complaint alleged that a bank's foreign operations and loans, although "depicted with enthusiasm" in the company's 1973 through 1975 annual reports were, in fact "speculative and risky". The Second Circuit (Friendly, J.) focused upon the absence in the complaint of any "specification of what loans, at what times, and in what amounts were 'risky,'" and concluded that "[i]n the absence of such particulars, and given the myriad of foreign loans made by the Bank during the early 1970's, the simple use of the epithet 'risky' is no better than a 'mere conclusory allegation to the effect that defendant's conduct was fraudulent.'" 576 F.2d at 469. The court reached the same conclusion with regard to allega-

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4. (...continued)
Feb. 10, 1992); *Gollomp v. MNC Fin. Inc.*, 756 F. Supp. 228, 232 n.4 (D. Md. 1991) (fraud claim not supported by speculation that procedures were not conservative because of the later failure of loans); *Wilkes v. Heritage Bancorp., Inc.*, 767 F. Supp. 1166, 1173 (D. Mass. 1991) (complaint dismissed pursuant to Rule 9(b) because "plaintiffs' complaint does not give details of a single loan or transaction which was imprudent or made in violation of standard banking procedure"); *Dubowski v. Dominion Bankshares Corp.*, 763 F. Supp. 169, 172 (W.D. Va. 1991) (plaintiffs "have to do more than contrast quarterly and yearly statements"), *subsequent motion to dismiss denied*, No. 90-647-R (W.D. Va. Dec. 11, 1991) (certified for interlocutory appeal to 4th Cir.); *Haft v. Eastland Financial Corp.*, 755 F. Supp. 1123, 1128 (D.R.I. 1991) ("The 'how' of this complaint is so general that it . . . might apply to any financial institution in the Northeast"); *Vachon v. Baybanks, Inc.*, 780 F. Supp. 79, 82 (D. Mass. 1991) ("[t]he precipitous rise of loan loss reserves does not of itself indicate fraud"); *Zimmerman v. Shawmut*, No. 2:91 CV00258, 1991 WL 274342 at *6 (D. Conn. Dec. 13, 1991) ("plaintiff does no more than . . . compare [the recent loan loss] report with similar information from earlier reports, and conclude that the differences . . . must be attributable to fraud"); *Abrahamson v. Clark*, No. 88-1677, 1989 WL 259996, at *4 (D. Ariz. July 7, 1989) (dismissing conclusory claim that defendants "failed to adequately provide loan loss reserves"), *aff'd mem.*, 951 F.2d 358 (9th Cir. 1991).

tions that the bank fraudulently failed to disclose early enough the "fact" that other kinds of loans and investments were "speculative and risky,":

> Again, no specification of transactions is provided, and there is not even an indication of the date at which defendants knew the investments had become so unacceptably 'risky' that disclosure was required. The defendant is entitled to a narrower delineation of the charges than the plaintiff has provided.

Id. at 469-70. As Judge Friendly observed, while "greater clairvoyance" might have led to the realization in 1973 that petroleum prices might increase dramatically later that year, and in 1976 that New York City would come to the verge of bankruptcy late in that year, "failure to make such perceptions does not constitute fraud." *Id.* at 470.

The Third Circuit, prior to the *UJB* decision, was in agreement with such Circuits' approach. *See Christidis*, 717 F.2d at 100 (upon which, *inter alia*, *DiLeo* relied), discussed *infra*, at 20. Indeed, a different panel of the Third Circuit reached this same conclusion as *Christidis* on the same day as the decision in the instant case, adopting an approach contrary to *UJB* in a case involving a virtually identical complaint. *See Decker v. Landmark Sav. Ass'n*, No. 90-639, slip op. at 13-15 (W.D. Pa. June 12, 1991) (AII-23-25).

The practical effect of the Third Circuit's determination in *UJB* to sustain a fraud complaint based on the change in financial condition, is to hold that fraud by hindsight allegations *do* satisfy the pleading requirements of Rule 9(b). This is not the law in any of the circuits. The Seventh Circuit in *DiLeo* recently rejected precisely this type of fraud by hindsight pleading under Rule 9(b):

> The story in this complaint is familiar in securities litigation. At one time the firm bathes itself in a favorable light. Later the firm discloses that things are less rosy. The plaintiff contends that the difference must be attributable to fraud. "Must be" is the critical phrase, for the complaint offers no information other than the differences

> between the two statements of the firm's condition. Because only a fraction of financial deteriorations reflects fraud, plaintiffs may not proffer the different financial statements and rest. Investors must point to some facts suggesting the difference is attributable to fraud.

901 F.2d at 627. The First, Second and Seventh Circuits have recognized that without the requirement that facts supporting the claim of wrongdoing be alleged, Rule 9(b) becomes a "paper tiger" that fails to fulfill its role of: requiring that a plaintiff investigate the facts and reasonably believe a fraud has occurred before filing suit; precluding unsubstantiated claims, the mere pendency of which injure the reputations of defendants; and preventing strike suits.[5] The Third Circuit itself recognized as much in *Christidis*, noting that "'[i]t has been the rule under both common-law and code pleading that allegations of fraud must be made with a great degree of particularity.'" 717 F.2d at 99 (citation omitted).

Some of these courts have relaxed somewhat the rigorous pleading standard under Rule 9(b) where the plaintiff has alleged that the facts lie solely within defendants' control. *See, e.g., DiVittorio v. Equidyne Extractive Indus., Inc.*, 822 F.2d 1242, 1217 (2d Cir. 1987); *Wayne Investments v. Gulf Oil Corp.*, 739 F.2d 11, 13-14 (1st Cir.

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5. *See, e.g., Seville Indus. Mach. Corp. v. Southmost Mach. Corp.*, 742 F.2d 786, 791 (3d Cir. 1984) (important purposes served by Rule 9(b)'s particularity requirements include: (1) ensuring that plaintiff has investigated and reasonably believes a fraud has occurred; (2) providing adequate notice to defendants so that they can respond to this claim; and (3) protecting the reputation of defendants), *cert. denied*, 469 U.S. 1211 (1985); *New England Data Servs., Inc. v. Becker*, 829 F.2d 286, 289 (1st Cir. 1987) (requirements of Rule 9(b) serve: "(1) to place the defendants on notice and enable them to prepare meaningful responses; (2) to preclude the use of a groundless fraud claim as a pretext to discovering a wrong or as a 'strike suit'; and (3) to safeguard defendants from frivolous charges which might damage their reputations"); *see also O'Brien v. National Property Analysts Partners*, 936 F.2d 674, 676 (2d Cir. 1991).

1984). However, the relaxed standard applied by these circuits does not change the particularity requirement of Rule 9(b) or excuse plaintiffs from pleading specific facts in support of the fraud allegation; rather, it permits a plaintiff who cannot plead supporting facts upon personal knowledge to instead plead the very same supporting facts upon information and belief. *See*, *e.g.*, *Romani*, 929 F.2d at 878 ("[t]he requirement that supporting facts be pleaded applies even when the fraud relates to matters peculiarly within the knowledge of the opposing party"); *DiVittorio*, 822 F.2d at 1247 (where facts are peculiarly within defendants' knowledge or control, plaintiff's allegations must be "accompanied by a statement of the facts upon which the belief is based"); *see also In re Verifone Sec. Litig.*, 784 F. Supp. 1471, 1487 (N.D. Cal. 1992) ("where knowledge of certain matters pertaining to fraud is peculiarly within the defendant's knowledge, the particularity requirement . . . is relaxed . . . . Nonetheless this special rule does not read Rule 9(b) out of existence") (citations omitted). *See generally* 2A J. Moore, *Moore's Federal Practice* ¶ 9.03[1], at 9-27-9-28 (2d ed. 1991) ("Where the facts are in the exclusive possession of the adversary, courts should permit the pleader to allege the facts on information and belief, provided a statement of the facts upon which the belief is founded is proffered").

The Third Circuit's decision in *UJB* relaxes this standard one giant—and qualitatively different—step further, stating:

> [E]ven under a more relaxed application of the rule, plaintiffs must accompany such an allegation with a statement of facts upon which their allegation is based. To avoid dismissal in these circumstances, a complaint must delineate at least the nature and scope of plaintiffs' effort to obtain, before filing the complaint, the information needed to plead with particularity.

964 F. 2d at 285 (citations omitted) (A-24). Thus, under the Third Circuit's newly-pronounced Rule 9(b) pleading standard, plaintiffs are not required to plead any facts giving rise to an inference of fraud. Instead, they merely are required to plead that the necessary information

supposedly exists but lies exclusively within defendants' control and that plaintiffs have been unable to discover any other facts to support their fraud claims (despite specified efforts to do so). This approach—which would let a plaintiff with *no* facts, just a "hunch," subject the defendants and the court to a full-scale litigation, at least through discovery and a summary judgment motion—is entirely contrary to the purposes and requirements of Rule 9(b) and the pleading standards in the First, Second and Seventh Circuits. The *UJB* standard guts the particularity requirement of Rule 9(b), leaving nothing but a complaint comprised of conclusory allegations and a statement by the plaintiff that it was unable to discover any facts supporting the assertion of fraudulent conduct. Such a standard renders Rule 9(b) meaningless in those situations in which the plaintiff has no facts showing that prior statements were false and is relying solely upon the change in financial condition between two different time periods to raise an inference of fraud in the earlier statements. Such standard, in effect, permits a fraud claim to survive if it satisfies the *de minimus* notice pleading requirements of Rule 8 (applicable to non-fraud pleadings), even if it does not satisfy Rule 9(b) (which was specifically drafted to govern fraud pleadings). Ironically, if, notwithstanding the allegation of a misstatement, there really has been no misstatement and thus there are no facts to plead how the challenged statement was inaccurate, the plaintiff could survive a motion to dismiss under the *UJB* standard by alleging what facts it believes exist and must be in defendants' control.

Under the Rule 9(b) standard articulated by the *UJB* panel—and contrary to this Court's teaching in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 741, *reh'g denied*, 423 U.S. 884 (1975), that in the securities law context, courts must be wary of "the possibility that a plaintiff with a largely groundless claim" will be able to use the discovery process to gain "an *in terrorem* increment of the settlement value"—a plaintiff may now commence and prosecute a fraud claim first, and hope either to coerce a settlement or to find facts, after subjecting defendants to lengthy and costly discovery, justifying the fraud charges levelled against defendants. *Compare Shields v. Washington Bancorporation*, No. 90-1101, 1992 WL 88004, at *8

(D.D.C. Apr. 7, 1992) ("Plaintiffs simply cannot allege the practices of the bank and a subsequent loss to make out a claim of fraud") and *id.* at *9 ("[w]ere the court to hold that plaintiffs' claims met Rule 9(b)['s] standard, anyone who had lost money on an investment would be able to sue for fraud. The only allegation necessary would be an unexpected financial setback. . . . With this one allegation plus the appropriate window-dressing by a good attorney, a claim would be born that might potentially have a substantial settlement value. Rule 9(b) must require more than this").

The Third Circuit's approach amounts to "issu[ing] a license for a fishing expedition in uncharted waters" (*Wayne*, 739 F.2d at 14) and is antithetical to one of the fundamental premises of our system of jurisprudence: a plaintiff is required to have sufficient facts to state a claim *before* filing the complaint; a plaintiff cannot file a fraud complaint and then force defendants to undergo the costs and other burdens of litigation while plaintiff tries to learn whether there really are (or are not) any facts to support its mere suppositions of wrongdoing. *Denny v. Barber*, 73 F.R.D. 6, 10 (S.D.N.Y.), *aff'd*, 576 F.2d 465 (2d Cir. 1978) ("[c]omplaints should not be conceived merely as tokens, guaranteeing access to a world of discovery . . . . Neither plaintiff nor his counsel are entitled to roam through a defendant's files at the mere drop of a 'complaint'"); *McFarland v. Memorex*, 493 F. Supp. 631, 639 (N.D. Cal. 1980). Contrary to these decisions, which reject a pleading standard under which a plaintiff can "shoot first" and "ask questions later" (i.e., plead fraud and hope to find something to support the charge in discovery), the Third Circuit decision in *UJB* suggests that such is an acceptable approach. In doing so, the Third Circuit subjects defendants to hundreds of thousands of dollars of legal fees in discovery and additional expense in connection with motions for summary judgment after discovery, as well as disruption of business as a result of extraordinary burdens on employees and management while plaintiff takes discovery; and thus grants plaintiff precisely what this Court long ago recognized as the "*in terrorem* increment of the settlement value" of a case without underlying merit. *Blue Chip Stamps*, 421 U.S. at 741.

2. Confusion Among the District Courts

The pleading standard established by the Third Circuit further complicates the already inconsistent application of Rule 9(b) by sending a signal to the lower courts that pleading fraud by supposition is acceptable as long as plaintiff has alleged that the facts needed to allege fraud lie solely within the defendant's control and further alleges the efforts plaintiff has made (without success) to find such supposed facts that would support its fraud claim. In light of the far-reaching implications of the Third Circuit's evisceration of Rule 9(b) in this context, and the already confused and inconsistent decisions of the district courts in applying Rule 9(b), it is essential for this Court to intervene.

Even prior to the *UJB* decision, district courts in and out of the Third Circuit have been utterly inconsistent, and often directly at odds with each other, with respect to the application of Rule 9(b). The same lawyers can (and do) file the same complaint against the same kinds of defendants; and depending upon which court—or even which judge within a court—hears the case, the results will be diametrically opposed. Some district courts require that facts be pled indicating how the alleged wrongful conduct was fraudulent, while other courts uphold complaints which simply (1) quote verbatim from the alleged misrepresentation, (2) provide the context in which the representations were made, and (3) identify the various defendants involved in the alleged fraud. *Compare Fox v. Equimark Corp.*, 782 F. Supp. 295, 300 (W.D. Pa. 1991) (plaintiff must allege more than the descriptions of the situation before and after the financial reverses and allege that difference must be due to fraud; rather, plaintiff must allege facts suggesting that the difference was attributable to fraud); *Heller v. NCNB Corp.*, 768 F. Supp. 167, 169 (W.D.N.C. 1991) ("complaint basically recites a series of financial reports, press releases and other information available to the public and then alleges that these were all false and misleading. . . . The complaint falls far short of providing an adequate factual basis for an inference of fraud and scienter"); *Wilkes v. Heritage Bancorp, Inc.*, 767 F. Supp. 1166, 1174-75 (D. Mass. 1991) ("must be" theory of fraud pleading not acceptable; court requires that plaintiff allege

factual details with respect to fraudulent conduct in particular loans, accounting practices or bank procedures); and *Mancini v. Prudential-Bache Fogelman Harbour Town Properties, L.P.*, No. 90-C-5213, 1991 WL 171966 at *6 (N.D. Ill. Sept. 3, 1991) ("[w]hile the projections [of operating revenues] are clearly different from the tale that was being told in [a later report], these differences alone do not bespeak fraud absent some facts suggesting that the differences are attributable to fraud") (citation omitted); *with In re Midlantic Corp. Shareholder Litig.*, 758 F. Supp. 226 (D.N.J. 1990) (complaint need not contain facts alleging why wrongful statements are fraudulent; complaint withstands Rule 9(b) challenge where pleadings contain quotes from alleged misrepresentation, and allege when these statements were made and who made them); *Nicholas v. Poughkeepsie Sav. Bank/FSB*, [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,606, at 97,836 (S.D.N.Y. Sept. 26, 1990) (same). (See also *supra*, pp.10-11). As a result, similar complaints filed in different district courts even within the same Circuit are receiving disparate treatment based upon a federal rule which should be applied uniformly.

The Third Circuit's decision in *UJB* will exacerbate the confusion among the district courts. District courts in the Third Circuit must choose between applying the *Landmark* or *UJB* decision--issued the same day, but taking opposite approaches—and district courts from other circuits may decide to adopt *UJB*'s unsound reasoning where their own Circuit has not spoken on the issue. The Third Circuit's position that a complaint claiming securities fraud under the federal law need not allege facts supporting the claim that a statement was false, but may be based solely upon a statement that plaintiffs have not yet uncovered the necessary facts, combined with an explanation of the efforts undertaken to uncover such facts, is unsound. This Court should reject that position and provide the lower courts with the uniform pleading standard which is sorely lacking.

B. Intra-Circuit Conflict In Applying Rule 9(b)

The pleading standard set forth by the Third Circuit in *UJB* also is inconsistent with the Third Circuit's opinions in *Christidis* and *Decker v. Landmark Sav. Ass'n*, No. 91-

3776 (3d Cir. May 20, 1992), a case, ironically, decided on the same day as *UJB*. In *Christidis*, 717 F.2d at 99, the Third Circuit affirmed dismissal of a complaint setting forth allegations (as here) relating to inadequate loan loss reserves, because Rule 9(b) requires "that the complaint state with particularity the circumstances constituting the fraud," and a plaintiff *must* show "how" a defendant's conduct was fraudulent in order to satisfy the particularity requirement. The court's requirement in this regard was the same as that which had been (or thereafter was) adopted by other circuits. *See*, *e.g.*, *Romani*, 929 F.2d at 878; *DiLeo*, 901 F.2d at 627 (citing *Christidis*); *Denny*, 576 F.2d at 470.

The Third Circuit in *Landmark* issued an order affirming the District Court's dismissal of the complaint with prejudice, expressly "for the reasons set forth in two opinions of Magistrate Judge Ila Jeanne Sensenich which was adopted by the district court." (AII-6) As in *UJB*, the complaint dismissed in *Landmark* alleged that the defendants had violated Sections 10(b) and 20(a) of the Exchange Act by making false and misleading statements concerning the bank's loan loss reserves, earnings and income, lending practices and internal management and credit controls. Unlike the *UJB* panel, the Third Circuit in *Landmark* affirmed the lower court's dismissal, acknowledging the critical requirement under Rule 9(b) set forth both in *Christidis* and by other circuits: plaintiff must allege "how" the statement was fraudulent or why defendants should have been on notice of the statement's falsity. The Third Circuit in *Landmark* reaffirmed the Rule 9(b) standard adopted by that circuit in both *Christidis* and *Craftmatic* that "[e]ven under a nonrestrictive application [of] . . . rule [9(b)], . . . [plaintiffs'] allegations must be accompanied by a statement of the facts upon which the allegations are based." *Landmark*, No. 90-639 slip op. at 11 (W.D. Pa. June 12, 1992) (AII-21).[6]

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6. *In re Craftmatic Securities Litig.*, 890 F.2d 628, recognized that "even under a non-restrictive application of [Rule 9(b)], pleaders must (continued...)

Remarkably, the pleadings dismissed in *Landmark* for lack of particularity contained defects identical to those identified by the District Court Judge, but excused by the Third Circuit, in *UJB*: the complete absence of any facts within the pleadings that demonstrate *how* defendants' conduct, when undertaken, was fraudulent.

> [Plaintiffs] do not identify *the way* in which Landmark's commercial business and residential real estate loan portfolios were risky. They do not identify *how* defendants exaggerated Landmark's earnings and net worth . . . . Plaintiffs allegations are broad and conclusory and lack factual support. As to plaintiffs' claim that Landmark failed to adequately reserve against loss, it is noted that in *Christidis* . . . the court held that the plaintiff's claim that defendants' financial statements understated the reserves which the trust should have accrued for bad debts [sic] did not sufficiently allege fraud with the specificity required by Rule 9(b) and was properly dismissed.

Landmark, slip op. at 13-14 (emphasis added) (AII-23-24).

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6. (...continued)
allege that the necessary information lies within defendants' control, and their allegations must be accompanied by a statements of the facts upon which the allegations are based." *Id.* at 645. The *Craftmatic* court interpreted the latter requirement to mean that plaintiffs who plead a fraud claim based upon information and belief instead of personal knowledge "must accompany their allegations with facts indicating why the charges against defendants are not baseless and why additional information lies exclusively within defendants' control." *Id.* at 646. In other words, plaintiffs must plead facts demonstrating *why* the difference between "rosy" statements, for example, and later, less favorable results, is attributable to fraud. *DiLeo*, 901 F.2d at 627 (emphasis added). *Accord VT Investors v. R&D Funding Corp.*, 733 F. Supp. 823, 836-39 (D.N.J. 1990) (dismissing securities fraud and RICO claims pursuant to Rules 9(b) and 12(b)(6) because, even under a "relaxed pleadings standard," "plaintiffs have failed to point to any evidence that [the challenged] statements were false and misleading"; "the averment of fraud is mere suspicion").

The *UJB* opinion departs from previous and contemporaneous Third Circuit decisions in *Christidis*, *Craftmatic* and *Landmark*, as well as other Circuits' standards and Rule 9(b) itself, by disregarding the requirement that a plaintiff must plead facts to demonstrate that its claims are not baseless. Without the application of this requirement, the Third Circuit's approach in *UJB*, pays only lip-service to Rule 9(b)'s pleading requirements.[7]

The stark inconsistencies in the *UJB* and *Landmark* decisions, decided on the same day by two separate panels of the Third Circuit and reaching different conclusions regarding the allegations required to adequately plead fraud in federal securities law cases, should be considered by this Court in judging the merit of granting certiorari. This Court repeatedly has accepted certiorari when an intra-circuit conflict relates to a recurring and important issue or is accompanied, as here, by a widespread conflict among the circuits. *See*, *e.g.*, *Scarborough v. United States*, 431 U.S. 563, 567 n.4 (1977) (certiorari granted because of "split among the Circuits," one circuit noted as having an intra-circuit conflict); *Maggio v. Zeitz*, 333 U.S. 56, 59-60 (1948) (certiorari granted because of differing views within a circuit that was most frequently confronted with difficult bankruptcy issue); *Dickinson v. Petroleum Conversion Corp.*, 338 U.S. 507, 508 (1950) (certiorari granted "because of this intra-circuit conflict"); *John Hancock Mut. Life Ins. Co. v. Bartels*, 308 U.S. 180, 181 (1939) (certio-

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7. *See also*, as yet another example of the Third Circuit's inconsistency in interpreting Rule 9(b), *Seville Industrial Machinery Corp. v. Southmost Machinery Corp.*, 742 F.2d 786, 791 (3d Cir. 1984), *cert. denied*, 469 U.S. 1211 (1985), where the Third Circuit held that allegations of "date, place or time" are not required to plead fraud with particularity, so long as plaintiff "inject[s] precision and some measure of substantiation into their allegations of fraud," and which is irreconcilably in conflict with the First and Second Circuits' requirement that under Rule 9(b), fraud pleadings must specify the time, place, speaker and content of the alleged misrepresentation. *See DiVittorio v. Equidyne Extractive Indus., Inc.*, 822 F.2d 1242, 1247 (2d Cir. 1987); *Wayne Inv., Inc. v. Gulf Oil Corp.*, 739 F.2d 11, 13 (1st Cir. 1984).

rari granted because of intra-circuit conflict and the importance of the question). Given the *UJB* panel's denial of defendants' petition for rehearing, without this Court's intervention, the district courts in the Third Circuit will have no guidance as to whether it should follow *Landmark* or *UJB*, thus increasing the likelihood of numerous conflicting decisions.

C. The Third Circuit Decision Undercuts the Policies Underlying Rule 9(b)

The Third Circuit's newly-pronounced "relaxed" standard in effect equates Rule 8 and Rule 9(b), an equation that Congress, in adopting separate rules, and other Circuits, have declined to make. Other Courts of Appeals have recognized that, because of the serious implications to defendants of fraud charges and the resulting important purposes served by requiring that facts be pled in detail to support any such charges (see *supra*, pg. 25), Rule 9(b) imposes greater requirements than mere notice pleading permissible under Rule 8, applicable in actions which do not allege fraud. *See, e.g., Luce v. Edelstein*, 802 F.2d 49, 54 (2d Cir. 1986); *Hayduk v. Lanna*, 775 F.2d 441, 444 (1st Cir. 1985); *Friedlander v. Nims*, 755 F.2d 810, 813 n.3 (11th Cir. 1985).

Rule 9(b) serves a particularly important purpose because in the securities litigation context, the problem of strike suits and coercion of settlements is exacerbated by the high stakes involved and the potential for extensive, costly discovery regarding groundless claims. *See*, in addition to *Blue Chip*, *supra*, *Romani*, 924 F.2d at 878; *Konstantinakos v. FDIC*, 719 F. Supp. 35, 38 (D. Mass. 1989) ("[R]ule [9(b)] is especially important in securities fraud cases where the strike suit value of a complaint is high"). Absent some requirement that plaintiffs do more than quote the statements from an early annual report and then from a later, less favorable one, and allege in conclusory fashion that the earlier, more positive one reflects fraud, the securities laws become nothing more than either an insurance policy guaranteeing that the shareholder is placed in a "no lose" situation, *DiLeo*, 901 F.2d at 627, or an *in terrorem* weapon to coerce settlements. As this Court recognized in *Blue Chip Stamps v. Manor Drug*

Stores, 421 U.S. 723, 741 (1975), enforcing threshold pleading requirements in the context of securities litigation operates to diminish the possibility:

> that a plaintiff with a largely groundless claim [will be able] to simply take up the time of a number of other people [by extensive discovery], with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the process will reveal relevant evidence. . . .

The First Circuit, following this rationale, has emphasized that courts should be "especially rigorous in demanding . . . factual support in the securities context to minimize the chance 'that a plaintiff with a largely groundless claim will bring a suit and conduct extensive discovery in the hopes of obtaining an increased settlement, rather than in the hopes that the process will reveal relevant evidence.'" *Romani*, 929 F.2d at 878 (citation omitted). Unlike the First Circuit, the Third Circuit has failed to heed the words of this Court. The Third Circuit would now sanction such pleadings even where plaintiff has no facts other than a comparison of the two disclosures. As recently noted by one commentor, the Third Circuit's decision in *UJB* opens the floodgates for the pursuit of fraud claims without any facts indicating that a fraud has occurred. Brodsky, *Suits Resulting From The Banking Crisis*, N.Y.L.J. July 30, 1992, at 3.

In advocating its "wait until after discovery" approach to delaying the dismissal of unsubstantiated fraud claims, the Third Circuit has eliminated an effective tool in combating what this Court has recognized to be the "widespread abuse of discovery that has become a prime cause of delay and expense in civil litigation." *Herbert v. Lando*, 441 U.S. 153, 179 (1979) (Powell, J., concurring); *see also* Kastenmeier & Remington, *Court Reform and Access to Justice: A Legislative Perspective*, 16 Harv. J. on Legis. 301, 303 (1979) ("the twin demons of cost and delay are asphyxiating our courts, both state and federal [with] pernicious effects on the quality of justice").

It is untenable that this Court would let stand a decision that supports the "sue first, find claims later" view

that has contributed to "a system so indulgent of dubious claims, defenses, and behavior that it [has fallen] prey to adversarial ethics, crowded dockets, rising litigation costs, abusive discovery and holdup litigation." Louis, *Intercepting And Discouraging Doubtful Litigation: A Golden Anniversary View Of Pleading, Summary Judgment, And Rule 11 Sanctions Under The Federal Rules Of Civil Procedure*, 67 N.C. L. Rev. 1023, 1028-1029 (1988).

In permitting factually unsupported charges of fraud to rise to the level of a federal securities law claim, the Third Circuit not only ignores the consequences its determination may have upon the court system, but also disregards the important task of safeguarding the reputation of defendants whose only protection against conclusory charges of fraud contained in publicly-filed pleadings is that afforded by judicial enforcement of Rule 9(b). As the Second Circuit in *Decker v. Massey-Ferguson, Ltd.*, 681 F.2d 111 (2d Cir. 1982) (*citing Segal v. Gordon*, 467 F.2d 602, 607 (2d Cir. 1972)), stated:

> It is a serious matter to charge a person with fraud and hence no one is permitted to so do unless he is in a position and is willing to put himself on record as to what the alleged fraud consists of specifically.

Id. at 115. The need to safeguard a defendant's reputation under Rule 9(b) is unquestionable in the current economic environment. Rarely, if ever, have federal courts been so inundated with a continuous stream of virtually identical lawsuits containing allegations so general that they could be filed against any financial institution suffering in our declining economy. *See Shields v. Amoskeag Bank Shares Inc.*, 766 F. Supp. 32, 38 (D.N.H. 1991). The Third Circuit would permit such pleadings-by-photostat to stand no matter what the cost to defendants' reputations or to the court system.

A more subtle danger with the Third Circuit's approach is its implicit impingement on another of this Court's decisions, *Santa Fe Industries v. Green*, 430 U.S. 462 (1977). *Santa Fe* held that claims of mismanagement or breach of fiduciary duty do not rise to the level of violations of Section 10(b). This Court held that Congress, in

enacting Section 10(b), "'did not seek to regulate transactions which constitute no more than internal corporate mismanagement,'" *id.* at 479 (*citing Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12 (1971)), and recognized the "danger of vexatious litigation which could result from a widely expanded class of plaintiffs under Rule 10b-5." *Id.* (citation omitted). By permitting a Section 10(b) claim to stand without requiring the plaintiffs to set forth facts detailing (in accordance with Rule 9(b)) their fraud by hindsight allegations, the Third Circuit has condoned the filing of federal securities law claims based upon plaintiffs affixing conclusory characterizations of fraud to conduct that would, at most, amount to possible mismanagement. As the court in *In re The One Bancorp Securities Litigation*, 135 F.R.D. 15 (D. Me. 1991), recognized when dismissing claims which contained only conclusory allegations that a bank's provision for loan losses was fraudulent, "plaintiffs must allege more than internal corporate mismanagement to satisfy [the pleading requirements of] Rule 9(b)." *Id.* at 14.[8]

The Third Circuit in *UJB* recognizes and adopts the *Santa Fe* position with respect to its analysis of plaintiffs' allegations of inadequate loan loss reserves or improper or imprudent lending and credit monitoring practices, under Rule 12(b)(6) (*see* 964 F.2d at 281) (A-17); yet it inconsistently ignores *Santa Fe* when undertaking its Rule 9(b) analysis. For example, as the district court here correctly recognized, plaintiffs' allegations that UJB's earnings were overstated as a result of inadequate loan loss reserves without pleading facts indicating how, or in what manner, the challenged statements were fraudulent, reflects no more than a disagreement with the company's judgment as to the appropriate level of loan loss reserves or a claim of mismanagement which does not deserve scrutiny by the

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8. Ironically, the *Landmark* court, in dismissing under Rule 12(b)(6) allegations virtual identical to those at issue in *UJB*, found that "[w]hile these [fraud by hindsight] claims might support a claim of mismanagement by defendants, *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), recognized that mismanagement is not a basis for a federal claim." *Landmark*, slip op. at 13 (AII-23).

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federal courts.[9] The Third Circuit's decision, in contrast, is inconsistent with the holding and rationale of *Santa Fe*. By excusing a plaintiff from pleading facts to support the conclusory characterization of conduct as fraudulent, the Third Circuit departs not only from Rule 9(b) but even Rule 12(b)(6), pursuant to which the Courts examine whether the *facts* pleaded, not the plaintiff's self-serving conclusions or characterizations contained in the complaint, are sufficient to state a claim. *See generally* 5 C. Wright & A. Miller, *Federal Practice and Procedure* § 1357, at 311-21 (2d ed. 1990) (pleadings of conclusions or characterizations of fact, without pleading of facts themselves, should *not* be accepted by the Court); 2A J. Moore & J. Lucas, *Moore's Federal Practice* ¶ 12.07 [2.-5], at 12-63-64 (2d ed. 1991).

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9. As the Third Circuit recognized in *UJB*, the setting of a loan loss reserve is an economic judgment which can only be validated at some later date. 964 F.2d at 281 (A-17). Indeed, reserves are simply an estimate or prediction of future losses. *See Christidis v. First Pa. Mortgage Trust*, 717 F.2d 96, 100 (3d Cir. 1983) ("reserves were estimates or predictions of the likely collection or liquidation experience"); *TCF Banking & Sav. F.A. v. Arthur Young & Co.*, 706 F. Supp. 1408, 1412 (D. Minn. 1988) (establishment of loan loss reserve "involves economic forecasting, not the reporting of known facts"). The governing FASB Statement No. 5 of Financial Accounting Standards specifically requires that the loss be both *probable and reasonably estimable* before it is accrued. *Financial Accounting Standards Boards, Accounting Standards - Current Text - General Standard, Contingencies as of 1990* at ¶ C59.105 (losses from uncollectible receivables (such as principal and interest on loans) shall be accrued when both conditions (probable and reasonably estimable) are met).

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II. THE THIRD CIRCUIT'S STATEMENT THAT COMMENTING ON A MATTER MAKES SUCH MATTER *PER SE* MATERIAL CONFLICTS WITH THE DECISION OF THIS COURT IN *BASIC*

Having announced a new and incorrect standard pursuant to which plaintiffs may allege fraud without pleading facts as to how and why the challenged statement was false, the Third Circuit then compounded its error as to the pleading standard by ignoring—indeed, taking the approach expressly rejected in—this Court's prior decision governing the materiality of any such challenged statement. As a result, certiorari should be granted pursuant to Sup. Ct. R. 10.1.(c). The Third Circuit's statement in *UJB* that "[b]y addressing the quality of a particular management practice, a defendant declares the subject of its representation to be material to the reasonable shareholder, and thus is bound to speak truthfully" (964 F.2d at 282 (A-18)), flatly ignores *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). In *Basic*, this Court considered and rejected the rule proposed by the Sixth Circuit that "information concerning ongoing acquisition discussions becomes material by virtue of the statement denying [its] existence." 485 U.S. at 237. The Third Circuit—which *sua sponte* raised the point, without the benefit of any briefing or argument, much less discussion of *Basic's* holding—thus has attempted to revive the very same reasoning rejected by this Court.

In *Basic*, this Court held that a plaintiff must "show that the statements were *misleading* as to a *material* fact. It is not enough that a statement is false or incomplete, if the misrepresented fact is otherwise insignificant." 485 U.S. at 238 (emphasis in original). As this Court further expressly recognized, "materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information." *Id.* at 240. The Third Circuit, however, has incorrectly stated that such an analysis is not necessary once a statement has been made and disseminated to the public.

CONCLUSION

The total effect of the *UJB* decision is that: (i) plaintiffs can satisfy the pleading requirement under Rule 9(b) simply by alleging that a statement was false, without possessing or pleading the facts showing how or why the statement was false; and (ii) by pleading the mere fact that the statement was made, plaintiff may establish materiality, without more, in direct contravention of *Basic*. Thus, for example, under the Third Circuit's decision here, plaintiffs' claim based upon UJB's statement that its lending policies were prudent could withstand a motion to dismiss under Rule 9(b) without plaintiff pleading any facts showing how or why UJB's lending policies were not prudent; and such statements, simply by virtue of the fact that they were made would be regarded as material.

The danger of leaving undisturbed the Third Circuit's erroneous decision on these issues goes far beyond the boundaries of this particular case, because district courts within the Third Circuit and other courts without the circuit well might rely on such precedent to effectively abolish the pleading requirement under Rule 9(b) and to adopt a reading of *Basic* inconsistent with this Court's holding and intent. This Court has the ability to prevent the flood of litigation that will ensue should the Third Circuit's newly-pronounced pleading standard under Rule 9(b) and misstatement of this Court's holding in *Basic* be left undisturbed.

Accordingly, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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Filed: May 20, 1992

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 91-5153

IRWIN SHAPIRO, on behalf of himself
and all others similarly situated

v.

UJB FINANCIAL CORP.;
T. JOSEPH SEMROD; and
JOHN R. HAGGERTY

Irwin Shapiro, Robert Bassman,
Jerome Katz, Norman Salsitz,
Jean Lee, Executrix of the
Estate of Calvin Lee, and
Chappaqua Family Trust

Appellants

On Appeal from the United States District Court
for the District of New Jersey
(D.C. Civil Action No. 90-01569)

Argued September 17, 1991
Before: BECKER and SCIRICA, *Circuit Judges*
and VanARTSDALEN*, *District Judge*

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*The Honorable Donald W. VanArtsdalen, United States District Judge for the Eastern District of Pennsylvania, sitting by designation.

(Filed: May 20, 1992)

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OPINION OF THE COURT

SCIRICA, *Circuit Judge*.

This case is one of a number of federal securities actions against financially troubled banking institutions. After a sharp downturn in the financial condition of defendant UJB Financial Corporation, its shareholders filed a complaint alleging violations of §§ 11, 12(2), and 15 of the Securities Act of 1933 and §§ 10(b), 14(a) and 20(a) of the Securities Exchange Act of 1934, and various pendant state law claims. These claims are predicated on allegedly false and misleading statements made by UJB and other defendants regarding the company's loan loss reserves, earnings and income, lending practices, and internal management and credit controls.

The district court dismissed most of plaintiffs' federal claims for failure to state a claim upon which relief could be granted and for failure to plead with particularity. Fed. R. Civ. P. 12(b)(6), 9(b). The court also found that plaintiffs failed to state a common law claim for negligent misrepresentation. We will affirm in part and reverse in part.

I. BACKGROUND

Defendant UJB Financial Corporation, a New Jersey based bank holding company that offers a wide range of financial services, consists of 12 member banks and 11 non-bank subsidiaries.[1] Its common and Series B preferred stock are traded on the New York Stock Exchange. When plaintiffs' complaint was filed, UJB had more than $11

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1. This factual narrative is drawn from the complaint.

billion in assets, $7 billion in outstanding loans, and $8 billion in total consolidated deposits. The remaining defendants are individuals who were UJB officers[2] and directors[3] during the relevant time period, February 1, 1988 to July 18, 1990.

From 1987 to 1989, UJB saw substantial growth in assets, earnings, net income, and net worth. Total loans increased from $6.5 billion to $8.3 billion, total assets from $10.1 billion to $12.1 billion, and net income from $102 million to $118 million. The company's periodic announcements, made in quarterly and annual reports, press releases, and governmental filings, often contained more than just routine recitations of financial figures. The announcements repeatedly referred to UJB's "prudent," "cautious," and "conservative" lending policy, its "strict" credit administration practices, its "minimal" foreign loan exposure, and its "basic" approach to loan management. There were also frequent references to UJB's adherence to "sound" and "time-tested" banking practices, the "high" quality of its loan portfolio, and its "high safety margin." UJB also represented that its loan loss reserves were "strong" or "very Strong," and had been and would continue to be "maintained at a level determined adequate." The bank further attributed its overall success to its "strategy" of limiting its business dealings to the New Jersey region and avoiding concentration on a few large projects.

The first sign of a downturn appeared in March, 1990, when UJB filed a 10-K Report with the Securities and Exchange Commission. The accompanying 1989 Annual Report stated that the provision for loan losses had been increased as a "prudent" measure, and asserted that the loan loss reserves, which had recently been augmented by

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2. T. Joseph Semrod (President and Chief Executive Officer of UJB and Chairman of its Board of Directors); Clifford H. Coyman (President, Chief Executive Officer, and Director); and John R. Haggerty (Chief Executive Officer and Senior Vice President).

3. Robert L. Boyle, Elinor J. Ferdon, Walter L. Dealtry , Fred G. Harvey, Francis J. Mertz, Henry S. Patterson, II, James A. Skidmore, Jr., and Joseph M. Tabak. All served on UJB's Audit Committee during 1989.

13.1%, were "at a level determined adequate." The same Annual Report contained an interview with UJB's President and Chief Executive Officer, Joseph Semrod, who attributed the increase in bad loans to the cyclical nature of the banking business, a slow economy, and problems in residential real estate construction and development. He noted, however, that this part of UJB's loan portfolio was "well secured," and that UJB continued to have "good loan to value ratios." He projected "continued solid growth," but conceded that UJB was "budgeting a smaller real estate portfolio."

UJB's troubles escalated in March and April of 1990 when three financial evaluation services—Moody's Investors Service, Fitch Investors Service, and Standard & Poors—downgraded their ratings of UJB debt, stock, and commercial paper, as well as their ratings of deposits belonging to UJB's principal bank subsidiary, United Jersey Bank. These analysts expected UJB's credit quality to deteriorate, particularly with regard to real estate, construction, and land development loans.

On April 18, 1990, UJB issued a press release announcing a dramatic decline in net income and an equally striking increase in its loan loss reserves and non-performing assets. Semrod nevertheless reassured the public that the "long term is what counts," and that UJB was both "positioned for the '90s and beyond" and "focused on maximum sustainable, long-range earning growth and maximum long-term return." On July 18, 1990, UJB issued another press release announcing that the company's loan loss provision was four times what it had been the year before, and that earnings and income had dropped again. The price of UJB's common stock, which had been as high as $27 per share in the prior three years, plummeted to approximately $10 per share.

In reaction to these developments, plaintiff shareholders filed this class action. They attribute their economic losses to "a campaign [by defendants] to depict the illusion of UJB as a growing, profitable and vital lending institution with conservative lending practices, and a system of internal controls proper to ensure adequate collateralization and prompt recognition and accounting for problem loans." According to plaintiffs, defendants' public announcements in

the years 1988-1990 portrayed UJB "in a falsely optimistic manner" by stating that the loan loss reserves were adequate, loan review procedures and policies were stringently and continuously applied, lending opportunities were balanced appropriately against risks, and financial results were positive.

The claims of the plaintiff class[4] are grouped into three separate Counts. Count I alleges that defendants misrepresented and failed to disclose material information in violation of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1988), and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 (1991). Count I also alleges that the individual defendants are liable as "controlling persons" under § 20(a) of the Exchange Act, 15 U.S.C. § 78t (1988), for UJB's alleged § 10(b) violations. Count II avers that representations made in certain UJB registration statements and prospectuses violated §§ 11 and 12(2) of the Securities Act of 1933. 15 U.S.C. §§ 77k(a), 77l(2) (1988). In addition, it alleges that the individual defendants are liable to certain members of the plaintiff class as "controlling persons" under § 15 of the Securities Act, 15 U.S.C. § 77o (1988). Finally, Count III charges that defendants negligently misrepresented and omitted material information in violation of their common law duty of care.[5] The complaint sets forth many detailed

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4. The plaintiff class consists of all persons who purchased UJB's publicly traded securities between February 1, 1988 and July 18, 1990.

5. The district court did not dismiss Count IV, in which individual plaintiff Chappaqua Family Trust asserted a claim under § 14(a) of the Securities and Exchange Act, 15 U.S.C. § 78n (1988). The Trust voluntarily withdrew this claim with prejudice during the pendency of this appeal. At oral argument, however, defendants suggested that the withdrawal of Count IV was improper because plaintiffs failed to give notice and opportunity to be heard to members of the plaintiff class. This argument is unavailing because Count IV was asserted by the Chappaqua Family Trust, not the class representatives. See Complaint ¶ 79. Therefore, we need not and do not address whether a class representative may withdraw a § 14(a) claim without giving the class notice and opportunity to be heard.

(continued...)

factual allegations in support of these claims, but paragraph 52 summarizes them all.[6]

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5. (...continued)

The district court dismissed Count V, which alleged a breach of fiduciary duties under New Jersey corporate law. This dismissal has not been appealed.

6. Paragraph 52 provides:

"During the Class Period, the defendants, individually and in concert, directly and indirectly, engaged and participated in or aided and abetted a continuous course of conduct and conspiracy to conceal adverse material information regarding the finances, financial condition and future prospects of UJB as specified herein. Defendants employed devices, schemes, and artifices to defraud and engaged in acts, practices, and a course of conduct as hereinafter alleged in an effort to maintain artificially high market prices for the securities of UJB. This included the formulation, making of and/or participation in the making of untrue statements of material facts and omitting to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, and engaging in acts, practices, and courses of business which operated as a fraud and deceit upon plaintiffs, and the Class. These included, among other things, the following:

(a) that the earnings, assets, and net worth of UJB were improperly and materially overstated and inflated throughout the Class Period due to grossly inadequate provisions for loan loss reserves;

(b) that the defendants caused UJB to continually understate its non-performing loans and failed to provide adequate loan loss reserves for problem loans promptly and properly, and instead granted extensions, further credits, and other beneficial loans to its problem loan customers, in order to postpone improperly the recognition of said problems in the publicly disseminated financial statements of UJB;

(c) that UJB's total loan loss reserves, particularly reserves for construction loans, were not maintained at an adequate level in light of the economic conditions prevailing in certain areas of loan concentration and the concomitant high risk of non-collectibility of a large portion of UJB's commercial real estate and other loans;

(continued...)

6. (...continued)

(d) that, many of UJB's larger problem loans, including but not limited to construction loans, and other loans in the Company's commercial loan portfolios, were not adequately collateralized or secure, contrary to defendants [sic] representations that:

- 'our portfolio is well secured' and 'we continue to have good loan to value ratio' . . . ;
- the Company's 'construction and real estate related loans . . . are . . . well collateralized . . . ;'
- that UJB had 'high asset quality' . . .

(e) that UJB's credit review and authorization standards and policies and system of internal controls to assure adequate collateralization and prompt recognition and accounting for problem loans were not conservative, were not functioning adequately or were being disregarded, not followed or circumvented by senior officers of the Company in order to maintain artificially high reported loan and earnings growth, contrary to defendants' representations that:

- that UJB adheres to 'conservative policies . . . in quickly recognizing non performing assets' . . .;
- that UJB had, '[I]n our effort to minimize our risk . . . followed conservative underwriting standards' with respect to construction and development loans . . .;
- that UJB's 'corporate policy toward residential, industrial and commercial construction loans' were 'conservative, cautious and therefore, profitable' . . .;
- that UJB's loan quality was strong because the Company was 'paying attention to the basics of loan administration' . . .;
- that 'quality' was a 'guiding principle in [UJB's] loan portfolio' . . .;
- that UJB had a 'lending philosophy which emphasizes the prompt identification and follow up of problem loans' and a 'conservative approach to problem loan recognition' . . .;
- that UJB 'emphasize[d] the basics of proper loan origination

(continued...)

Defendants filed a motion to dismiss, which the district

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6. (...continued)

procedures and good credit administration' and 'carefully monitor[s] our portfolio and . . . maintain[s] a strong allowance for loan losses . . .' . . .;

- that UJB had been 'prudent' in construction lending . . . and;

- that UJB had a 'prudent lending philosophy' . . .

(f) that, UJB's lending practices and controls were not sufficiently centralized, were unmanageable, and UJB's commercial lending officers had engaged in high risk and speculative loan transactions, which were not being adequately supervised, controlled, or directed by higher management, contrary to defendants' representations as set forth herein;

(g) that UJB would be required to add substantial additional amounts to its loan loss reserves as a result of its lending practices, contrary to defendants representations that:

- that UJB had a 'low level of non performing loans,' a 'very strong allowance for loan losses' and 'solid loan loss reserve' . . .;

- that UJB's loan loss reserves were 'maintained at a level determined adequate to provide for potential losses on loans' . . . .

(h) that by announcing increases in non-performance loans or increases in reserves at various times during the Class Period (including but not limited to announcements or statements dated October 18, 1989, January 16, 1990, March 15, and April 15, 1990), defendants failed to disclose the full truth regarding UJB's problem loans and lack of controls and, indeed, gave the materially false and misleading impression that UJB had taken all steps that were necessary or appropriate in connection with UJB's problem loans; and

(i) that given the existence of these undisclosed facts concerning UJB, its business, financial condition and performance, finances and future prospects, any investment in UJB involved an extraordinary high degree of risk."

Complaint ¶ 52.

court granted in part and denied in part. The district court dismissed with prejudice all claims in Counts I and II "to the extent that they rely on ¶¶ 52(a), (b), (c), (f), and (g) of the amended complaint, and to the extent that they rely upon allegations of mismanagement in ¶¶ 52(d) and (e)." It also dismissed with prejudice the § 15 claim in Count II and the negligent misrepresentation claim in Count III. The § 11 and § 12(2) claims of Count II were dismissed for failure to state a claim upon which relief could be granted, but the district court gave plaintiffs 30 days to amend their complaint to remedy defects identified in its opinion. Finally, the district court specifically upheld the § 20(a) "controlling person" claim in Count I.

The district court found that the remaining allegations in Counts I and II based on subparagraphs 52(d), (e), (h) and (i) did not satisfy Federal Rule of Civil Procedure 9(b), which requires that fraud be pleaded with particularity. However, the court did not formally dismiss these allegations. Instead, it granted plaintiffs 30 days to amend the complaint. The court also ordered class representative Jerome Katz to post $50,000 as security in connection with the § 11 and § 12(2) claims. Following this order, plaintiffs formally announced that they would neither amend their complaint nor provide security, and instead filed a timely appeal from the district court's order. Defendants moved to dismiss the appeal.

II. JURISDICTION

Defendants asset that there is no final appealable order because several claims were not formally dismissed by the district court.[7] According to defendants, the following two groups of claims rendered the district court's order non-final: (1) all claims asserted in Counts I and II, to the extent they rely upon allegations of fraud in subparagraphs 52(d), (e), (h), and (i) of the complaint, and (2) the § 20(a) claim asserted in Count I. We will address these contentions in turn.

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7. The courts of appeals have jurisdiction over appeals "from all final decisions of the district courts of the United States," 28 U.S.C. § 1291 (1988).

A. § *10(b), § 11, and § 12(2) Claims*

The major obstacle to appellate jurisdiction involves the allegations that did not satisfy Rule 9(b). Ordinarily, such claims are dismissed with leave to amend. Here, however, the district court did not dismiss but rather granted leave to amend, stating that "to the extent that plaintiffs do not submit these amendments within thirty days, the court will entertain a renewed motion to dismiss." No amendment was submitted, and the district court never formally dismissed the claims. Plaintiffs maintain that they cured any finality problems by announcing they would stand on their complaint and would not amend.

Guided by the Supreme Court's directive that we employ a "practical rather than a technical construction" of § 1291's finality requirement, *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 546 (1949), we have held that a plaintiff can convert a dismissal with leave to amend into a final order by electing to stand upon the original complaint. *See, e.g., Borelli v. City of Reading*, 532 F.2d 950, 951-52 (3d Cir. 1976) ("Only if the plaintiff . . . declares his intention to stand on his complaint . . . the order becomes(s) final and appealable"). Plaintiffs here formally stood on their complaint, but defendants contend that this was not enough. They maintain that we lack jurisdiction because plaintiffs failed to obtain an explicit dismissal with prejudice. We do not agree.

The district court stated it would entertain a renewed motion to dismiss if plaintiffs did not amend, but gave no indication that it would reconsider its earlier rulings. It seems clear that the district court planned to dismiss with prejudice any claims not amended. Requiring plaintiffs to return to the district court now would be a wasteful elevation of form over substance. *See Schrob v. Catterson*, 948 F.2d 1402, 1407 (3d Cir. 1991); *but see Hatch v. Lane*, 854 F.2d 981, 982 (7th Cir. 1988). Thus, once the amendment period expired, the district court's order had the effect of dismissing the improperly pleaded claims with prejudice.

Our analysis is supported by *Bankers Trust Co. v. Mallis*, 435 U.S. 381 (1978), where the United States Supreme Court addressed the effect of the parties' failure to comply with Federal Rule of Civil Procedure 58 on appel-

late jurisdiction. Rule 58 provides that no "decision by the [district] court that . . . all relief shall be denied" is effective until the clerk of the district court prepares, signs, and enters a separate "judgment" that is both "set forth on a separate document" and noted on the docket sheet. Fed. R. Civ. P. 58. The Court held that the parties were free to waive these requirements because the timing of the appeal was not in doubt. *Id.* at 384. The Court noted that:

> Certainty as to timeliness . . . is not advanced by holding that appellate jurisdiction does not exist absent a separate judgment. If, by error, a separate judgment is not filed before a party appeals, nothing but delay would flow from requiring the court of appeals to dismiss the appeal. Upon dismissal, the district court would simply file and enter the separate judgment, from which a timely appeal would then be taken. Wheels would spin for no practical purpose.

Id. at 385.

We believe that no practical purpose would be served if we were to dismiss this appeal. Defendants do not question the timeliness of the appeal. *See Jung v. K. & D. Mining Co.*, 356 U.S. 325 (1958). Nor is there any doubt that the district court would, on remand, simply dismiss the defective claims left unamended, not revise its earlier reasoning. *Id.* at 337. Therefore, we will treat the district court's order as a final dismissal.

B. § *20(a) Claim*

Plaintiffs contend that § 20(a) does not create a separate cause of action, but rather depends entirely on the viability of § 10(b) claims. They maintain that "controlling person" liability can exist only if primary liability has been established as to another defendant. Therefore, once all predicate § 10(b) claims are dismissed, there are no allegations upon which § 20(a) liability can be based. We agree.

Section 20(a) imposes joint and several liability on any person who "controls a person liable under any provision

of" the Securities Exchange Act of 1934.[8] The text of the statute plainly requires the plaintiff to prove not only that one person controlled another person, but also that the "controlled person" is liable under the Act. If no controlled person is liable, there can be no controlling person liability. *Wool v. Tandem Computers Inc.*, 818 F.2d 1433, 1440-1 n.8 (9th Cir. 1987). Here the dismissal of the § 10(b) claims against UJB made it impossible to hold the individual defendants liable under § 20(a).

There being no other extant claims, we are satisfied that the district court's order was final, and that we have jurisdiction over this appeal.

III. DISCUSSION

Plaintiffs make four principal arguments on appeal. First, they maintain that they have alleged fraud under § 10(b) with sufficient particularity, rather than mismanagement. Second, they contend that the same allegations state actionable § 11 and § 12(2) claims and are grounded in negligence rather than fraud. Third, they argue that they have properly alleged negligent misrepresentation under New Jersey law. Finally, they challenge the district court's order requiring class representative Katz to post security.

Our review of the district court's dismissal of the complaint for failure to state a claim upon which relief can be granted is plenary. We must accept as true the factual allegations contained in the complaint, and may affirm the dismissal only if it appears certain that plaintiffs can prove no set of facts that would entitle them to relief. *Ransom v.*

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8. This section provides:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t(a) (1988).

Mariazzo, 848 F.2d 398, 401 (3d Cir. 1988). We also have plenary review of the district court's interpretation of the federal securities laws, *Dent v. Cunningham*, 786 F.2d 173, 174 (3d Cir. 1986), and its determination of New Jersey law. *Salve Regina College v. Russell*, ___ U.S. ___, 111 S. Ct. 1217 (1991). Finally, we review the district court's requirement of security for abuse of discretion. 15 U.S.C. § 77k(e) (1988).

A. *Section 10(b)*

Under the authority provided by § 10(b) of the Exchange Act of 1934,[9] the Securities and Exchange Commission promulgated Rule 10b-5,[10] which make it unlaw-

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9. Section 10(b) of the Securities Exchange Act of 1934 makes it unlawful for any person

> directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange --
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative device or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1988).

10. Rule 10b-5 provides that it is unlawful for any person

> directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any

(continued...)

ful to misrepresent or omit material information in connection with the purchase or sale of securities. 17 C.F.R. § 240.10b-5 (1991). To state a claim under § 10(b) and Rule 10b-5, a private plaintiff must plead (1) a false representation of (2) a material (3) fact, (4) the defendant's knowledge of its falsity and his intention that the plaintiff rely on it, (5) the plaintiff's reasonable reliance on the representation, and (6) the plaintiff's resulting loss. *Lewis v. Chrysler Corp.*, 949 F.2d 644, 649 (3d Cir. 1991).

1 *Rule* 12(b)(6)

As we have noted, the thrust of the complaint is that UJB and the individual defendants misrepresented the true status of the company's loan loss reserves, financial health, lending practices, and internal controls. The district court found that many of the alleged misrepresentations or omissions involved either failures to predict or mismanagement —not fraud—and were not actionable under the federal securities laws.

The basis for the district court's decision was *In re Craftmatic Sec. Litig.*, 890 F.2d 628 (3d Cir. 1990), where we held that "[w]here the incremental value of disclosure is solely to place potential investors on notice that management is culpable of a breach of faith or incompetence, the failure to disclose does not violate the securities laws." *Id.* at 640. In *Craftmatic* we provided an extensive review of the Supreme Court's jurisprudence on materiality,[11] noth-

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10. (...continued)
person,

in connection with the purchase or sale of any security

17 C.F.R. § 240.10b-5 (1991).

11. An omitted fact is material if there is a "substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder." *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). In other words, the issue is whether there is a substantial likelihood that the disclosure would have been viewed by the reasonable investor as having "significantly altered the 'total mix' of information" available to that
(continued...)

ing that the courts are "reluctant to permit a federal securities claim to stand when the plaintiff has failed to allege more than nondisclosure of mismanagement." *Id.* at 639.

Because it plays such a prominent role in the complaint, we will briefly discuss the nature of a loan loss reserve, which is defined in the banking trade as a

> statement of condition, or balance sheet, account set up by a bank based on its expectations about future loan losses. As losses occur, they are charged against this reserve. That is, the loan account is credited and the reserve account is debited. The reserve is established by a debit to an expense account called the loan loss provision, with a corresponding credit to the loan loss reserve.

American Bankers Association, *Banking Terminology* 215 (1989). There appears to be no single method of evaluating and setting loan loss reserves, perhaps because no method has proven foolproof. C. Edward McConnell, *Loan Loss Reserve Management and Unwise Lending Practices, in Bank Credit* 354 (Herbert V. Prochnow ed. 1981). Some banks set their loan loss reserves by comparing the size of the reserves to that of the loan portfolio. *See* Keith G. Turman, *Evaluating a Bank's Loan Loss Reserve Adequacy*, Internal Auditor, February 1991, at 5253. Others also analyze the quality of their loans in varying degrees of detail and according to a range of different criteria and classifications. *See, e.g., id.*; Ronald A. Stollers, *Loan Loss Reserve Analysis: Is It Moving From Art to Science?*, Banking Policy Report, April 1, 1991, at 4; Francis X. Conway & William A. Stegenthaler, *Loan Loss Reserves:*

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11. (...continued)
investor. *Craftmatic*, 890 F.2d at 639. Materiality is a mixed question of law and fact, and the delicate assessments of the inferences a reasonable shareholder would draw from a given set of facts are peculiarly for the trier of fact. *TSC*, 426 U.S. at 450. Only if the alleged misrepresentations or omissions are so obviously unimportant to an investor that reasonable minds cannot differ on the question of materiality is it appropriate for the district court to rule that the allegations are inactionable as a matter of law. *Id.*

Tax, Regulatory, and Adequacy Issues, J. of Com. Bank Lending, Sept. 1987, at 4; Victor F. Ptasznik, *Another Approach to Calculating the Loan Loss Reserve*, J. of Com. Bank Lending, April 1987, at 7; Jerry Abner, *Calculating the Loan Loss Reserve from a Watch List*, J. of Com. Bank Lending, August 1985, at 2. All techniques, however, require quantitative and qualitative analyses of the past and present status of loans. *See* Conway & Stegenthaler, *Loan Loss Reserves, supra*, at 9 ("Relying on standardized, nondiscretionary formulas to aid in the determination of loan loss reserves is oversimplifying a complex problem."); *see also* Allowance for Loan and Lease Losses for Federal Branches and Agencies, Office of Comptroller of the Currency, Banking Circular 201, Fed. Banking L. Rep. (CCH) ¶ 51,132 (May 31, 1985) (describing minimum assessment customarily undertaken by soundly managed banks). No matter what method is used, the economic judgments made in setting loan loss reserves can be validated only at some future date. McConnell, *supra*, at 354-55.

There is nothing unique about representations and omissions regarding loan loss reserves that removes them from the purview of the antifraud provisions of the federal securities laws. In our view a reasonable investor would be influenced significantly by knowledge that a bank has knowingly or recklessly hidden its true financial status by deliberately misstating its level of non-performing loans, failing to provide adequate reserves, and indulging its problem loan customers. *See In re Midlantic Corp. Shareholder Litigation*, 758 F. Supp. 226, 234 (D.N.J. 1990). On the other hand, mere failure to provide adequate reserves (or to perform competently other management tasks) does not implicate the concerns of the federal securities laws and is not normally actionable. Similarly, if a defendant has not commented on the nature and quality of the management practices that it has used to reach a particular statement of loan loss reserves, earnings, assets, or net worth, it is not a violation of the securities laws to fail to characterize these practices as inadequate, meaningless, out of control, or ineffective. *Craftmatic*, 890 F.2d at 633 n.5 & 640 (dismissing allegations that defendants failed to disclose general subjective assessments of controls, organization, and management information systems).

However, where a defendant affirmatively characterizes management practices as "adequate," "conservative," "cautious," and the like, the subject is "in play." For example, if a defendant represents that its lending practices are "conservative" and that its collateralization is "adequate," the securities laws are clearly implicated if it nevertheless intentionally or recklessly omits certain facts contradicting these representations. Likewise, if a defendant characterizes loan loss reserves as "adequate" or "solid" even though it knows they are inadequate or unstable, it exposes itself to possible liability for securities fraud. By addressing the quality of a particular management practice, a defendant declares the subject of its representation to be material to the reasonable shareholder, and thus is bound to speak truthfully.

Our decision that such general labels as "conservative" and "cautious" can be the basis for liability under Rule 10b-5 is supported by the Supreme Court's recent decision in *Virginia Bankshares, Inc. v. Sandberg*, ___ U.S. ___, 111 S. Ct. 2749 (1991). In that case, the executive committee and board of directors of a bank approved a merger proposal that would pay its minority shareholders $42 per share. The directors solicited proxies for voting on the proposal at the company's annual meeting. In the solicitation sent to minority shareholders, the directors stated that the merger was an opportunity to achieve a "high" value at a "fair" price. *Id.* at ___, 111 S. Ct. at 2756. After the merger was approved, the plaintiff filed a complaint alleging violations of SEC Rule 14a-9, which prohibits the making of false or misleading statements of material fact in —and the omission of material facts necessary to make existing statements not false or misleading from—a proxy statement. 17 C.F.R. § 240.14a-9 (1991). Specifically, the plaintiff alleged that the directors had not in fact believed that the price offered was "high" or that the terms of the merger were "fair."

The Supreme Court rejected the defendants' argument that statements of opinion or belief were not "material." After noting that a fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote, the Court commented that

> there is no room to deny that a statement of belief by corporate directors about a recommended course of action, or an explanation of their reasons for recommending it, can take on just that importance. Shareholders know that directors usually have knowledge and expertness far exceeding the normal investor's resources, and the directors' perceived superiority is magnified even further by the common knowledge that state law customarily obliges them to exercise their judgment in the shareholders' interest.

Id. at ____, 111 S. Ct. at 2757.

If a director's statement of belief is material because of the speaker's superior knowledge, then a manager's statement of belief must also be material. A manager's knowledge and expertise regarding the day-to-day operation of his company generally exceeds that of a director, and the reasonable investor is aware of this fact. Even if management sometimes acts in its own interest, a reasonable investor need not take a manager's statement of belief at anything less than face value.

Virginia Bankshares also rejected the argument that statements of reasons, opinions, or beliefs are not "factual" for purposes of the securities laws. Such statements, said the Court, "are factual in two senses: as statements that the directors do act for the reasons given or hold the belief stated and as statements about the subject matter of the reason or belief expressed." *Id.* at ___, 111 S. Ct. at 2758.

> Reasons for directors' recommendations or statements of belief are . . . characteristically matters of corporate record subject to documentation, to be supported or attacked by evidence of historical fact outside a plaintiff's control. . . .
>
> . . . .
>
> It is no answer to argue, as petitioners do, that the quoted statement on which liability was predicated did not express a reason in dollars and cents, but focused instead on the 'indefinite and unverifiable' term, 'high' value, much like the similar claim that the merger's terms were 'fair' to shareholders. The objection ignores the fact that *such conclusory terms in a commercial context are reasonably understood to rest on a*

> *factual basis that justifies them as accurate, the absence of which renders them misleading*. Provable facts either furnish good reasons to make a conclusory commercial judgment, or they count against it, and expressions of such judgments can be uttered with knowledge of truth or falsity just like more definite statements, and defended or attacked through the orthodox evidentiary process that either substantiates their underlying justifications or tends to disprove their existence.

Id. at ___, 111 S. Ct. at 2758-59 (emphasis added). For these reasons, plaintiffs here are "permitted to prove a specific statement of reason knowingly false or misleadingly incomplete, even when stated in conclusory terms." *Id.* at ___, 111 S. Ct. at 2759. We believe that the evaluations of management practices and financial well being alleged here are as conclusory (and as provable) as those in *Virginia Bankshares*.

In this case, plaintiffs accuse defendants of knowingly or recklessly misrepresenting that they thought UJB's:

- loan loss reserves were "adequate," "adequately maintained," "strong," and "solid" (¶ 52 (a), (b), (c), (e));

- loan portfolio was "well secured," "well collateralized," and of a high "quality" (¶ 52 (d));

- loan to value ratio was "good" (¶ 52(d));

- loan management and underwriting practices were "conservative," "basic," "careful," "good," "prudent," and "cautious," (¶ 52(e));

- asset quality was "high," while their level of bad loans was "low" (¶ 52(d), (g)); and

- internal controls not only existed, but were properly centralized, supervised, and managed (¶ 52(f), (g), (h)).

Moreover, plaintiffs allege that the published figures relating to earnings, assets, and net worth were knowingly or recklessly "overstated and inflated." ¶ 52(a). In light of our discussion, all of these statements, if made knowingly or recklessly, are actionable.

Nevertheless, not all the allegations made in paragraph 52 are actionable. As we have noted, it is not a violation of the securities laws to simply fail to provide adequate loan loss reserves; properly collateralize or secure a loan port-

folio; or provide sufficient internal controls or loan management practices.

Moreover, as the district court recognized, some of the pivotal allegations charge defendants with essentially failing to predict the future. As we pointed out previously, "where an event is contingent or speculative in nature, it is difficult to ascertain whether the reasonable investor would have considered the omitted information significant at the time. *Craftmatic*, 890 F.2d at 643 (quoting *Basic, Inc. v. Levinson*, 485 U.S. 224, 232 (1988) (internal quotation marks omitted)). For example, plaintiffs allege here that UJB failed to reveal that the loan loss reserves were inadequate in light of the "high risk of non-collectibility" (¶ 52(c)); and that UJB "would be" required to add substantial amounts to its loan loss reserves in the future (¶ 52(g)). Plaintiffs do not, however, allege that defendants possessed or made affirmative forecasts regarding these possible outcomes. *See Craftmatic*, 890 F.2d at 644. Thus, there is no allegation that defendants omitted "soft information" that can, in some circumstances, be actionable. *Flynn v. Bass Bros. Enterprises*, 744 F.2d 978 (3d Cir. 1984). For this reason, these particular allegations contained in subparagraphs 52(c) and (g) were properly dismissed.[12]

Having established the applicable principles of law, we would ordinarily leave it to the district court to evaluate the remaining paragraphs and subparagraphs of the complaint, including the balance of paragraph 52. However, plaintiffs' style of pleading has made it difficult to parse the complaint, primarily because many of the actionable allegations were intermingled with the inactionable. Moreover, the

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12. Our discussion of the strengths and weaknesses of paragraph 52 also applies to the preceding and succeeding paragraphs. Some of these allegations can, under the principles announced, be the basis for a § 10(b) claim. Others suffer from the defects already identified. For example, paragraph 25 alleges that a UJB quarterly report included a statement that "United Jersey looks to the future with great optimism." This allegation is clearly inactionable puffing. Moreover, many allegations refer to defendants' statements about specific figures. If these statements were material misrepresentations, they may be actionable; if they were merely the product of mistakes in calculation, they are not.

manner of pleading obscures what plaintiffs are in fact alleging. For example, subparagraph 52(c) alleges that UJB's "total loan reserves, particularly reserves for construction loans, were not maintained at an adequate level." This language, taken in isolation, is plainly an allegation of inactionable mismanagement. The preamble to paragraph 52, however, states that defendants made "untrue statements of material facts," and then lists several allegations, including subparagraph 52(c). It is difficult to discern whether plaintiffs are alleging that defendants made material statements that the reserves were adequate when in fact they were not, or whether plaintiffs are merely alleging that the reserves were inadequate. We are also troubled by certain syntactical problems. For example, subparagraph 52(a), in conjunction with the prefatory text, states:

> These included, among other things, the following: that the earnings, assets, and net worth of UJB were improperly and materially overstated and inflated throughout the Class Period due to grossly inadequate provisions for loan loss reserves.

It is difficult to comprehend this allegation. We do not believe that plaintiffs are alleging that the overstatement and inflation was caused by inadequate provision of loan loss reserves, yet this is what the paragraph appears to say. Similar ambiguities occur elsewhere.

Given the procedural history of this case, we would not ordinarily be disposed to offer plaintiffs yet another opportunity to revise their complaint. However, in light of the confusion that pervades plaintiffs' allegations, we conclude that the entire complaint must be reorganized. Therefore, on remand plaintiffs should rearrange the existing allegations into discrete units that are, standing alone, each capable of evaluation under the legal principles we have set forth. Because of the procedural history here, plaintiffs may not add to the existing factual allegations in making their revisions. We also note that plaintiffs in future cases of this kind should plead clearly and coherently from the outset.

2. Rule 9(b)

Rule 9(b) requires a plaintiff to plead (1) a specific false representation of material fact; (2) knowledge by the person who made it of its falsity; (3) ignorance of its falsity

by the person to whom it was made; (4) the intention that it should be acted upon; and (5) that the plaintiff acted upon it to his damage. *Christidis v. First Pennsylvania Mortgage Trust*, 717 F.2d 96, 99 (3d Cir. 1983). Despite these stringent requirements, the courts should be "sensitive" to the fact that application of the Rule prior to discovery "may permit sophisticated defrauders to successfully conceal the details of their fraud." *Id.* at 99-100. They should also respect the "general simplicity and flexibility" of the Federal Rules of Civil Procedure. *Id.* at 100.

In *Christidis* we dismissed allegations that defendants knew or should have known that loan loss reserves were understated, improperly used and led to distortions of other financial data. Such allegations, we stated, could only succeed if, when the loan loss reserves were established, "the responsible parties knew or should have known that they were derived in a manner inconsistent with reasonable accounting practices." 717 F.2d at 100. We found the allegations deficient because they had not disclosed "the manner in which, in establishing reserves for bad debts in the financial statements relied upon, defendants knowingly departed from reasonable accounting practices." *Id.* Despite three amendments, plaintiffs had failed to state "[w]hat those practices are and how they were departed from." *Id.*

In *Craftmatic*, however, we recognized that:

> Particularly in cases of corporate fraud, plaintiffs cannot be expected to have personal knowledge of the details of corporate internal affairs. Thus, courts have relaxed the [particularity] rule when actual information is peculiarly within the defendant's knowledge or control.

890 F.2d at 645 (citations omitted). Nevertheless, we also held that at the very least plaintiffs must allege that the necessary information lies within defendants' control. *Id.* Although acknowledging that plaintiffs here cannot be expected to plead with specificity the details of UJB's internal corporate practices, the district court dismissed the remaining allegations for failure to allege defendants' exclusive control over this information. The complaint does not specifically allege that defendants have exclusive control of

information plaintiffs require.[13]

Had the complaint contained a boilerplate allegation that plaintiffs believe the necessary information "lies in defendants' exclusive control," it still would not have satisfied Rule 9(b). As we have noted, even under a more relaxed application of the rule, plaintiffs must accompany such an allegation with a statement of facts upon which their allegation is based. *Craftmatic*, 890 F.2d at 645; *Moore v. Kayport Package Express, Inc.*, 885 F.2d 531, 540 (9th Cir. 1989); 2A James W. Moore & Jo D. Lucas, *Moore's Federal Practice* ¶ 9.03[1] at 9-29 to 9-29 (1991) ("where the facts are in the exclusive possession of the adversary, courts should permit the pleader to allege the facts on information and belief, provided a statement of the facts upon which the belief is founded is proffered"). To avoid dismissal in these circumstances, a complaint must delineate at least the nature and scope of plaintiffs' effort to obtain, before filing the complaint, the information needed to plead with particularity. This requirement is intended to ensure that plaintiffs thoroughly investigate all possible sources of information, including but not limited to all publicly available relevant information, before filing a complaint. We will allow plaintiffs another opportunity to meet this

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13. The allegations cited by plaintiffs do not allege that the necessary information lies exclusively within defendants' control. Brief of Appellant Shapiro at 40 n.13. Rather, they allege only that defendants had access—but not exclusive access—to company information when the alleged misrepresentations and omissions occurred. *See* Complaint ¶ 6 (alleging that individual defendants had "access" to non public information at the time of the alleged misstatements and omissions); ¶ 51 (alleging that "[t]he true financial and operating condition of UJB, which was known or recklessly disregarded by defendants, remained concealed from the investing public" during the class period); ¶ 53 (alleging that defendants "could have obtained" knowledge of the facts during the Class period); and ¶ 58 (alleging that the plaintiffs would not have bought UJB securities during the Class period if they had known of materially adverse information "which was not disclosed by defendants").

standard.[14] Accordingly, we will reverse the district court's dismissal of subparagraphs 52(d), (e), (h) and (i) on Rule 9(b) grounds.

B. §§ *11 and 12(2)*

Count II alleges that UJB's Dividend Reinvestment and Stock Purchase Plan ("the DRISP") and the accompanying prospectus and registration statement were false and misleading, and that plaintiffs purchased UJB stock "pursuant to" all three documents.[15] Under the DRISP, shareholders

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14. Despite our reversal of the district court's dismissal on Rule 12(b)(6) grounds of subparagraphs 52(a), (b), (c), (f), and parts of subparagraphs 52(d) and (e), defendants urge us to affirm the dismissal on Rule 9(b) grounds. We leave it to the district court to evaluate in the first instance the particularity of these allegations.

The district court also dismissed Court II, which alleges that defendants violated §§ 11, 12(2), and 15, "to the extent that it relies on the points raised in" paragraph 52. Slip op. at 7. Our analysis with respect to Count I of the materiality and particularity of the fact allegations made in that paragraph also applies to Count II.

15. The key paragraphs of Count II are:

> 61. Class Plaintiff Jerome Katz, who purchased UJB's common stock during the Class period pursuant to the Company's Dividend Reinvestment Plan, bring [sic] this Count against defendant UJB on behalf of those members of the Class who purchased during the Class Period the Company's common stock pursuant to the DRISP prospectus.
>
> 62. In connection with the sale of the Company's common stock pursuant to the DRISP prospectus, defendant UJB was the 'seller' of such stock, within the meaning of Section 12(2) of the Securities Act of 1933.
>
> 63. The DRISP prospectus offering and describing the securities of UJB was false and misleading, *inter alia*, in the particulars previously described.
>
> 64. In ignorance of the false and misleading nature of the representations described above, members of the Class purchased UJB securities issued pursuant to the foregoing registration statements and prospectuses.

(continued...)

reinvested their dividends by purchasing additional UJB shares. *See* App. at 438. Some of these new shares were authorized but previously unissued treasury stock, but others were purchased by UJB in the secondary market. *Id.*

1. *Rule 12(b)(6)*

a. § *11*

Under § 11 of the Securities Act, any person acquiring a security issued pursuant to a false or misleading registration statement may recover damages. *See* 15 U.S.C. § 77k. Plaintiffs allege that they purchased UJB stock "pursuant to" a DRISP registration statement. The district court dismissed this claim, holding that although plaintiffs need not prove their shares are traceable to a false or misleading registration statement at this early stage of the litigation, they must allege it. We agree that traceability must be alleged, but our review of plaintiffs' complaint leads us to conclude that this has been done.

If plaintiffs' shares were purchased in the secondary market, they would not be linked to a registration statement filed during the class period, and the § 11 claim would fail. Before discovery takes place, however, it is impossible for plaintiffs to know whether their shares were newly issued or were purchased in the secondary market. The complaint alleges that the shares were purchase "pursuant to" the DRISP. At some point, plaintiffs may be able to prove that their DRISP shares came from treasury stock. Because we cannot say that plaintiffs can prove no set of facts that would entitle them to relief, the § 11 claim cannot be dismissed at this time.

b. § *12(2)*

Section 12(2) provides that a person who "offers or sells" securities by means of a prospectus or oral communication that misrepresents or omits material facts is liable to the person "purchasing such security from him." 15 U.S.C. § 771 (1988). The district court dismissed the § 12(2)

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15. (...continued)

The remaining paragraphs of Count II allege damage and petition for relief.

claim, finding insufficient plaintiffs' allegation that defendants were "sellers" within the meaning of the statute.

In *Pinter v. Dahl*, 486 U.S. 622 (1988), the Supreme Court held that the term "seller" under § 12(1) is not limited to the person who passes title to the security, but includes anyone "who successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interests or those of the securities owner." *Id.* at 647. In *Craftmatic* we extended *Pinter* to § 12(2). We interpreted *Pinter* as having held that

> the term "solicitation" does not encompass all activities related to the purchase transaction . . .
>
> . . . .
>
> Thus, although an issuer is no longer immune from § 12 liability, neither is an issuer liable solely on the basis of its involvement in preparing the prospectus. The purchaser must demonstrate direct and active participation in the solicitation of the immediate sale to hold the issuer liable as a § 12(2) seller.

890 F.2d at 636. We upheld allegations that each defendant "either sold [the] securities directly to plaintiffs . . . or solicited plaintiffs . . . and in so acting were motivated by a desire to serve their own financial interests or the financial interests of the owner(s) of [the] securities." *Id.* at 637.

Plaintiffs' complaint briefly describes the DRISP and alleges that "[i]n connection with the sale of the Company's common stock pursuant to the DRISP prospectus, defendant UJB was the 'seller' of such stock, within the meaning of § 12(2)." The district court held that this allegation was defective because plaintiffs must demonstrate "direct and active participation in the solicitation of the immediate sale." It found no factual allegation specifying how UJB had directly and actively participated in the immediate sale,and noted that the mere preparation of a prospectus was insufficient under *Craftmatic*. We disagree.

These plaintiffs were not required to allege that UJB directly "solicited" the sales. The *Pinter/Craftmatic* solicitation rule applies only when the defendant issuer is not in direct privity with the purchaser. *Pinter* adopted solicitation liability as an expansion of the restrictive view that § 12

extended only to sellers in direct privity. 486 U.S. at 644. In *Craftmatic*, because the securities were purchased from an underwriter acting as a middleman, the defendant was not in privity with plaintiffs. Here, however, the newly offered shares purchased through the DRISP were sold directly to plaintiffs by UJB. *See* App. at 438 ("Purchases of UJB Common Stock may be made directly from UJB or on the open market, at the discretion of senior management of UJB.").[16] Because plaintiffs need not allege that UJB directly and actively participated in solicitation of the purchase,[17] they have adequately alleged that UJB was a "seller" within the meaning of § 12.

2. *Rule 9(b)*

The district court held that the § 11 and § 12(2) allegations in Count II "sounded in fraud" and that Rule 9(b) applies. We agree.

Count II incorporates by reference all preceding factual allegations, including those delineating defendants' "intent." It also states that the DRISP prospectus was false and misleading "in the particulars previously described," and

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16. Because the DRISP prospectus provided that the shares would be purchased either directly from UJB or on the open market, the district court dismissed the § 12(2) claim because of plaintiffs' failure to "trace" their securities to an initial public offering. Our earlier analysis of traceability applies here. We therefore assume (for purposes of defendants' motion to dismiss) that plaintiffs' shares did not come from the secondary market, and that plaintiffs have sufficiently traced their shares to the DRISP prospectus. If defendants were eventually to prove that the shares came from the secondary market, § 12(2) would not apply, and judgment would be entered for them. *Ballay v. Legg Mason Wood Walker, Inc.*, 935 F.2d 682 (3d Cir.), *cert. denied*, ____ U.S. _____, 112 S. Ct. 79 (1991).

17. While we believe that plaintiffs should have alleged that UJB was a "direct" seller, they did allege that they bought their stock "pursuant to the DRISP prospectus." It is reasonable to infer from this allegation that plaintiffs did not purchase their shares through an intermediary. Judge Becker would hold that the present allegation is inadequate and that plaintiffs should have alleged specifically that UJB was a "direct" seller.

mentions the false and misleading nature "of the representations described above." Complaint ¶¶ 62-63. Although Count II does not allege fraudulent intent or recklessness (a prerequisite to a successful fraud claim), neither does it allege negligence. The specific factual allegations upon which Count II is based do, however, repeatedly aver that defendants "intentionally," "knowingly," or "recklessly" misrepresented and omitted to represent certain material information. For example, paragraph 53, which expressly purports to characterize all of the complaint's factual allegations, asserts that:

> Each of the defendants, by action as hereinabove described, did so knowingly or in such a reckless manner as to constitute a willful deceit and fraud upon plaintiffs and the members of the Class. With knowledge or reckless disregard of the true financial and operating condition of UJB, the Individual Defendants caused the reports, statements and releases, to contain misstatements and omissions of material fact as alleged herein . . .

Complaint ¶ 53. The only reasonable conclusion that can be drawn is that plaintiffs charge defendants with fraud. There is not a hint in the allegations that defendants were negligent in violating §§ 11 and 12(2).[18]

Plaintiffs contend that because Count II does not mention the intent required for fraud, we must necessarily infer that the claims are grounded in negligence. As defendants point out, however, Rule 9(b) refers to "averments" of fraud, and thus requires us to examine the factual allega-

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18. Buried in paragraph 13, which avers that common questions of law and fact predominate, is a brief mention of "whether the defendants acted willfully, recklessly or with gross negligence in omitting and/or misrepresenting material facts or in aiding and abetting the making of misstatements." It would be unreasonable to infer a negligence cause of action from this fleeting and obscure reference to "gross negligence." *Cf. United States v. Dunkel*, 927 F.2d 955, 956 (7th Cir. 1991). This conclusion is confirmed by plaintiffs' failure to cite to paragraph 13 when arguing that their § 11 and § 12(2) claims sound in negligence rather than fraud. *See* Brief of Appellant Katz at 9-18.

tions that support a particular legal claim. Plaintiffs also maintain that their incorporation by reference of earlier factual allegations should not "contaminate" Count II. We agree that a pleader should not be penalized for economizing. Here, however, only one paragraph preceding Count II refers to the DRISP. Quite simply, plaintiffs did not allege ordinary negligence there or anywhere else.

Moreover, we are not presented with a "mixture of allegations of negligence, fraud, and the misleading nature of" certain communications. *In re Consumers Power Co. Sec. Litig.*, 105 F.R.D. 583, 594 (E.D. Mich. 1985). As we have noted, the complaint is devoid of allegations that defendants acted negligently in violating §§ 11 and 12(2). Instead, it brims with references to defendants' intentional and reckless misrepresentation of material facts. We see no way to construct a negligence cause of action here.

Next we determine whether Rule 9(b) applies to § 11 and § 12(2) claims grounded in fraud, a question not yet decided in this court. *See Craftmatic*, 890 F.2d at 645 n.28 (leaving question open with regard to § 12(2)). It is clear that neither fraud nor mistake is a necessary element of either statutory cause of action. Under § 12(2) defendants may be held liable for negligent misrepresentation or omission. *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 687-88 (3d Cir. 1991); *Craftmatic*, 890 F.2d at 645 n.28 (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 208-09 (1976). The same is true of § 11. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983). By its plain wording, Rule 9(b) would not appear to apply to claims that a defendant negligently violated §§ 11 and 12(2); we need not and do not decide this issue. On the other hand, the plain language of the rule clearly encompasses § 11 and § 12(2) claims based on fraud like those before us. *See, e.g., Sears v. Likens*, 912 F.2d 889, 892-93 (7th Cir. 1990) (applying Rule 9(b) to § 12(2) claim). We see no valid reason to create a special exception to Rule 9(b) for such claims. Accordingly, we hold that when § 11 and § 12(2) claims are grounded in fraud rather than negligence, Rule 9(b) applies.

The district court did not address whether plaintiffs' § 11 and § 12(2) allegations were pleaded with sufficient particularity. Although we will remand for full considera-

tion of this issue, we offer the following guidance. The most serious flaw in the § 11 claim went unnoticed by the parties. Section 11 imposes liability for false or misleading statements made in "registration statements." 15 U.S.C. § 77k (1988). Paragraph 61 of the complaint alleges that Katz and those he represents purchased UJB stock pursuant to a DRISP "prospectus," not a registration statement. A prospectus generally makes up the bulk of the registration statement, contains nearly identical information, and serves many of the same disclosure purposes. However, it is a distinctly separate document under the federal securities laws. Paragraph 64 alleges that members of the class purchased UJB stock "pursuant to the foregoing registration statements," but no reference to a registration statement precedes paragraph 64. Indeed, paragraph 33 of the complaint describes the issuance of only a "prospectus" in connection with the DRISP. Thus, these allegations, even if true, do not provide even the "short and plain statement of the claim showing that the pleader is entitled to relief" required by Rule 8(a)(2), let alone the notice required by Rule 9(b).

The § 12(2) claim does identify the offending prospectus, but is only slightly more informative than the § 11 allegations. The complaint neither identifies which allegedly false statements violated § 12(2) nor explains how they were false. Under Rule 9(b), a plaintiff must allege the manner in which a defendant knowingly departed from the truth. *Christidis*, 717 F.2d at 100. As already noted, we are sensitive to the fact that premature application of Rule 9(b) can permit sophisticated defrauders to conceal fraud. *Id.* at 99-100. We are also aware that in cases of corporate fraud, plaintiffs cannot be expected to have personal knowledge of the details of corporate internal affairs. *Craftmatic*, 890 F.2d at 645. Nevertheless, "even under a non-restrictive application of the rule, pleaders must alleged that the necessary information lies within the defendants' control, and their allegations must be accompanied by a statement of the facts upon which the allegations are based." *Id.* The district court should, on remand, evaluate the particularity of the § 11 and § 12(2) claims in light of these comments.

C. *Negligent Misrepresentation*

The district court dismissed plaintiffs' supplementary state law claim for negligent misrepresentation, holding that

New Jersey law does not extend this cause of action to the general investing public. We disagree.

Under New Jersey common law, persons who negligently misrepresent material facts may be held liable to those who, as a result of their justifiable reliance on such misrepresentation, suffer economic harm. *H. Rosenblum, Inc. v. Adler*, 461 A.2d 138, 142-43 (N.J. 1983). In *Rosenblum* the New Jersey Supreme Court held that a buyer of stock may sue a corporation's outside auditor for negligent misrepresentations regarding the corporation's financial statements. In an exhaustive discussion, the court rejected the view that the plaintiff must be in privity with the auditor. Instead, "the independent auditor . . . has a duty to all those whom that auditor should reasonably foresee as recipients from the company of the statements for its proper business purposes." *Id.* at 142; *see also id.* at 146.

Rosenblum takes an expansive view of the range of permissible plaintiffs in a negligent misrepresentation action. It explicitly rejects the majority view that the plaintiff must be in privity, and adopts the more inclusive "reasonably foreseeable plaintiff" rule. There is no dispute here that the average investor was a reasonably foreseeable recipient of defendants statements about UJB. Defendants argue instead that investment by the general public is not a "proper business purpose." To state the argument is to note its defects. As one court has explained,

> Defendants . . . seek to parse out a subtle distinction between a "business decision" and an "investment decision." These terms . . . distinguish between an audit statement sent directly to an institutional investor to induce an investment and audit reports released to the general public for the same purpose. The contention is that the former investors are covered under the negligent misrepresentation doctrine while the ordinary public investor remains unprotected. *Rosenblum* makes no such distinction between these classes of reasonably foreseeable plaintiffs.

In re Midlantic Shareholders Litig., 758 F. Supp. 226, 237

n.9 (D.N.J. 1990).[19] Indeed, the *Rosenblum* court expressly stated that information sent to stockholders could be the basis of liability:

> When the defendants prepared the Giant audit, they knew . . . that it was to be incorporated in Giant's annual report, a report that would be transmitted to each Giant stockholder. . . . The defendants also knew or should have known that the audited financial statements would be available and useful for *other proper business purposes*, such as public offerings of securities . . .

461 A.2d at 154 (emphasis added). Moreover, the court looked to the expansive liability under the federal securities laws as a model for New Jersey law. *Id.* at 151. Therefore, it is not accurate to say that *Rosenblum's* "business purpose" requirement limits the cause of action to those who make "significant" investments.

In sum, we find that the New Jersey Supreme Court intended to part company with the majority of states that allow only plaintiffs who are in direct privity to sue for negligent misrepresentation. Therefore, we hold that this cause of action extends to foreseeable individual investors who, as a result of their reliance on negligently made misrepresentations, suffer economic loss.[20]

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19. At least four other district courts have held that New Jersey provides a negligent misrepresentation cause of action to the investing public. See *Urbach v. Sayles*, No. 91-1291, 1991 WL 236183 at *10-*11 (D.N.J. Sept. 4, 1991); *Gatman v. Howard Sav. Bank*, Fed. Sec. L. Rep. (CCH) ¶ 95,631 (D.N.J. 1990); *Bernstein v. Crazy Eddie, Inc.*, 702 F. Supp. 962, 982 (E.D.N.Y. 1988); *Kronfeld v. First Jersey Nat'l Bank*, 638 F. Supp. 1454, 1467 68 (D.N.J. 1986). *But see Cammer v. Bloom*, 711 F. Supp. 1264 (D.N.J. 1989).

20. In *Rosenblum*, the court commented that the negligent misrepresentation cause of action

> applies by its terms only to those foreseeable users who receive the audited statements from the business entity for a proper business purpose to influence a business decision of

(continued...)

D. *Security*

Under § 11(e) of the Securities Act, a district court "may, in its discretion, require an undertaking for the payment of the costs of [a Securities Act] suit, including reasonable attorney's fees."[21]

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20. (...continued)

> the user, the audit having been made for that business entity. Thus, for example, an institutional investor or portfolio manager who does not obtain audited statements from the company would not come within the stated principle. Nor would stockholders who purchased the stock after a negligent audit be covered *in the absence of demonstrating the necessary conditions precedent.*

Id. at 153 (emphasis added). It is not clear what the court meant by "the necessary conditions precedent." Perhaps it refers to reliance and the other elements of the cause of action. In any event, it is plain that *Rosenblum* does not foreclose liability to everyday investors.

Defendants also rely on *Karu v. Feldman*, 574 A.2d 420 (N.J. 1990), a post *Rosenblum* case. This reliance is misplaced. Although *Karu* found that the plaintiff did not state a claim for negligent misrepresentation, the decision did not turn on privity or the "business purpose" requirement. Rather, the court held that the defendant bank had not acted negligently because it had not provided certain false information to a depositor and had no duty to disclose other information. *Id.* at 427 28. *Karu* may support a finding that UJB had no duty to disclose certain information under New Jersey law, but it in no way supports the contention that a member of the investing public has no cause of action.

21. Section 11(e) provides:

> . . . In any suit under this or any other section of this title the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorneys' fees, and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if the court believes the suit . . . to have been *without merit*, in an amount sufficient to reimburse him for the reasonable ex-

(continued...)

The principal purpose of § 11(e) is to deter plaintiffs from bringing meritless actions solely to procure a favorable settlement. *Phillips v. Kidder, Peabody & Co.*, 686 F. Supp. 413, 416 (S.D.N.Y. 1986); *see also Hochfelder*, 425 U.S. at 211 n.30. Defendants concede that § 11(e) security is typically required "when the plaintiffs' action 'borders on the frivolous' *or* 'is brought in bad faith.'" Brief of Appellees at 55. The district court made no finding that Katz' claims met either of these standards. As we have seen, many of these claims are sufficient to withstand a motion to dismiss. Therefore, we will vacate the district court's security requirement.

IV. CONCLUSION

For the reasons stated, we will affirm in part and reverse in part the district court's dismissal of Counts I and II and remand for proceedings consistent with this opinion. Moreover, we will affirm the district court's decision that Rule 9(b) applies to the § 11 and § 12(2) claims,[22] but will remand for further determination of the sufficiency of the applicable allegations. We will also reverse the district court's dismissal of Count III. Finally, we will vacate the district court's order insofar as it requires class representative Katz to post security.

Each side shall bear its own costs.

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21. (...continued)

penses incurred by him, in connection with such suit, such costs to be taxed in the manner usually provided for taxing of costs in the court in which the suit was heard.

15 U.S.C. § 77k(e)(1988)(emphasis added).

22. The district court dismissed Count II's § 15 claim because the § 11 and § 12(2) claims to which it attached had been dismissed. In light of our revival of the latter claims, we will reinstate the § 15 claim for further consideration by the district court.

A True Copy:

Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

IN RE: UJB FINANCIAL CORP. SHAREHOLDER LITIGATION	:	MASTER FILE
	:	Civil No. 90-1569 (AET)
THIS DOCUMENT RELATES TO ALL ACTIONS	:	ORDER

For the reasons stated in this court's opinion of January 22, 1991, and upon consideration of the papers submitted, and for good cause

It is therefore on this 12th day of February, 1991

ORDERED that defendant's motion to dismiss the consolidated amended complaint be and hereby is granted in part and denied in part, in the following manner:

(1) Counts I and II are dismissed to the extent that they rely on ¶¶ 52 (a), (b), (c), (f), and (g) of the amended complaint, and to the extent that they rely on allegations of mismanagement in ¶¶ 52 (d) and (e) of the amended complaint. The claim in Count II for relief under § 15 of the Securities Act is dismissed. Counts III and V are dismissed;

(2) Plaintiffs are given thirty days from the date of this order to amend: Counts I and II, to the extent that they rely on the allegations in ¶¶ 52 (d), (e), (h) and (i), in order to comply with FED. R. CIV. PRO. 9(b); and the claims in Count II under §§ 11 and 12(2) of the Securities Act in order to comply with FED. R. CIV. PRO. 12(b)(6) and this court's opinion of January 22, 1991. To the extent that plaintiffs do not submit these amendments within thirty days, the court will entertain a renewed motion to dismiss;

(3) Plaintiffs claim in Count I under § 20(a), and Count IV are not dismissed;

and it is further

ORDERED that putative class plaintiff Katz, who seeks to assert a claim under sections 11 and 12 of the

Securities Act, provide security pursuant to such Act in the amount of $50,000.00 within five days of the date of this order, and it is further

ORDERED that the putative derivative plaintiff Chappaqua Family Trust provide security pursuant to N.J.S.A. section 14A:3-6 in the amount of $50,000.00 within five days of the date of this order.

ANNE E. THOMPSON, U.S.D.J.

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY
CIVIL ACTION NO. 90-1569 (AET)

IN RE: :
UJB FINANCIAL CORP. : TRANSCRIPT OF OPINION
SHAREHOLDER LITIGATION :

Monday, January 22, 1991
Federal Courthouse
Trenton, New Jersey

BEFORE: THE HONORABLE ANNE E. THOMPSON, U.S.D.J.

APPEARANCES:

BARRACK, RODOS & BACINE, ESQUIRES
BY: LEONARD BARRACK, ESQUIRE
ANTHONY BOLOGNESE, ESQUIRE
-and-
GREENFIELD & CHIMICLES, ESQUIRES
BY: LISA J. RODRIGUEZ, ESQUIRE
On behalf of Plaintiffs

EUGENE A. SPECTOR & ASSOCIATES
BY: PAUL SCARLATO, ESQUIRE
On behalf of Derivative Plaintiffs

WILENTZ, GOLDMAN & SPITZER, ESQUIRES
BY: FREDERIC K. BECKER, ESQUIRE
-and-
WEIL, GOTSHAL & MANGES, ESQUIRES
BY: IRWIN H. WARREN, ESQUIRE
BETH J. JACOBWITZ, ESQUIRE
On behalf of Defendants

Vincent Russoniello, CSR, RPR
Official Court Reporter
U.S. District Court
District of New Jersey
138 Paxson Avenue
Trenton, New Jersey 08690
(609) 588-9516

Pursuant to Section 753, Title 28 USC, the following transcript is certified to be an accurate transcription of my stenographic notes in the above-entitled matter.

Vincent Russoniello, CSR, RPR

THE COURT: This matter arises on defendants's motion to dismiss the complaint pursuant to Rules 9(b), 12(b)(6), 12(b)(1), and 23.1 of the Federal Rules of Civil Procedure.

Plaintiffs, in their complaint, seek damages arising from the alleged overstatement of UJB's financial condition through mismanagement and inadequate loan reserves. Plaintiffs maintain that they relied on fraudulent statements when purchasing stock which was overvalued as a result of defendants' actions. The complaint is comprised of several separate counts. Count I alleges violation of § 10(b) of the Securities Exchange Act of 1934 and SEC rule 10b-5. Count II claims that defendants violated §§ 11, 12 and 15 of the Securities Act of 1933. Count III is a state law claim of negligent misrepresentation. Count IV charges proxy violations under § 14(a) of the Security Exchange Act. Finally, Count V alleges breach of fiduciary duty. Plaintiffs premise their claims on a lengthy set of factual allegations, set out in ¶¶ 1-46 of the complaint. Rather than conduct a lengthy review of these assertions of fact, the court will refer where appropriate to those specific facts necessary to analyze the motion.

Rule 12(b)(6)

Defendants seek to dismiss Counts I and II for failure to state a claim upon which relief may be granted. They argue that these counts are based on allegations of mismanagement, and as such are not cognizable under the 1933 or 1934 Acts.

Mismanagement alone is an insufficient basis on which to base a claim under either act. Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 476-79 (1977); In re Craftmatic Securities, 890 F.2d 628, 638 n.14 (3d Cir. 1989). As well, claims based solely on "soft," speculative matters, such as failure to predict future performance, will not stand. Craftmatic at 640-44. "The Third Circuit has limited the application of the Santa Fe case . . . to those situations wherein plaintiffs do not allege material omissions or misstatements by defendants [which are] actionable under the securities laws." In re Avant-Garde Computing, Inc., Civ. No. 85-4149 (AET) at 14 (D.N.J. Sept. 5, 1989). Omissions or misstatements of mismanagement are not

actionable under security laws, however, where the essence of the claim alleges mismanagement, rather than misrepresentation. Craftmatic at 640.

Defendants argue that plaintiffs' claims amount to nothing more than mismanagement, deceptively framed as fraud claims. Plaintiffs counter that the claims are based on material omissions or misstatements concerning management policies and success, rather than on mismanagement itself. "[W]e must be alert to ensure that the purpose of Santa Fe is not undermined by 'artful legal draftsmanship;' [since] claims essentially grounded on corporate mismanagement are not cognizable under federal law." Craftmatic at 638-39 (emphasis added). Thus, we must determine the core nature of plaintiffs' factual allegations.

The issue revolves around the definition of "material facts." Only where the alleged mismanagement is material will the claim be cognizable. Determining what is material can be a difficult task.

> "The line between a material nondisclosure and the nondisclosure of mere mismanagement is often difficult to draw. Arguably, any action amounting to corporate mismanagement would be material . . . . However, courts have been reluctant to permit a federal securities claim to stand when the plaintiff has failed to allege more than nondisclosure of mismanagement. Where the incremental value of disclosure is solely to place potential investors on notice that management is culpable of a breach of faith or incompetence, the failure to disclose does not violate the securities acts." Id. at 639-40 (citations omitted).

Thus, we must examine each of the bases for Counts I and II in light of this vague standard, to determine whether they constitute material omissions or misstatements. Craftmatic provides some guidance. There, the court upheld the dismissal of claims that defendant failed to disclose that it was "unfocused" and "unable to manage" and that "its financial reporting and accounting controls [are] inadequate and ineffective." Id. at 640. These claims were essentially grounded in allegations of mismanagement, and as such did not involve "material" omissions. The court allowed claims, however, which were based on "the omission or

misrepresentation of information regarding Craftmatic's advertising, promotion, and marking program," where those activities were under investigation by several states. Id. at 646. These claims were based on specific omissions of facts which were material in nature.

Plaintiffs' factual allegations in Count I are contained in ¶ 52. Several of these claims, at their core, are nothing more than assertions of mismanagement. Others are a mixture of mismanagement and fraud, while some are fundamentally claims of fraud. The court finds that Count I is based on mismanagement rather than fraud so far as it relies on the following points:

> "[52](a) that the earnings, assets, and net worth of UJB were improperly and materially overstated in inflated . . . due to grossly inadequate provisions for loan loss reserves;
> (b) that the defendants caused UJB to continually understate its non-performing loans and failed to provide adequate loan loss reserves for problem loans promptly and properly, and instead granted extensions, further credits, and other beneficial terms to its problem loan customers . . . ;
> (c) that UJB's total loan loss reserves . . . were not maintained at an adequate level in light of the economic conditions . . .;[1]
> . . .
> (f) that, [sic] UJB's lending practices and controls were not sufficiently centralized, were unmanageable and UJB's commercial lending officers had engaged in high risk and speculative loan transactions, which were not being adequately supervised, controlled, or directed by higher management, contrary to defendants' representations . . .

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1. In Craftmatic, the court discussed "failure to predict" as a separate issue. That discussion centered around failure to release predictions to the public. Here, the crux of plaintiffs' claim is that defendants' failure to make predictions exhibited poor judgment, and so we deal with this claim as a management issue. See Craftmatic at 644. Under either analysis discussed in Craftmatic, however, this claim should be dismissed. Id.

(g) that UJB would be required to add substantial additional amounts to its loan loss reserves as a result of its lending practices, contrary to defendants representations . . . . [specific representations omitted]"[2]

In making this determination, the court notes that points (a), (b), and (c) did not even allege omissions or misstatements. Instead, they simply discuss specific ways in which defendants should have performed better. Further, while points (f) and (g) were presented in the context of fraud, the core of each point revolves around mismanagement. The alleged misstatements in (f) are only generally referred to. As well, defendants are not required "to place potential investors on notice that management is culpable of a breach of faith or incompetence." Craftmatic at 639-40. The specific representations referred to in (g) also do not rise to violations of the securities acts, because they only amount to speculative predictions. Id. at 640-44.

The following points present a mixed issue of fraud and mismanagement, so that Count I should be dismissed to the extent that it relies on those portions of the following points which revolve around mismanagement:

(d) that, [sic] many of UJB's larger problem loans . . . were not adequately collateralized or secure, contrary to defendants' representations that [representations omitted].

(e) that UJB's credit review and authorization standards and policies and system of internal controls to assure adequate collateralization and prompt recognition and accounting for problem loans were not conservative, were not functioning adequately or were being disregarded . . . contrary to defendants' representations that . . . . [representations omitted]"

Here, plaintiffs complain about defendants' business practices. However, they also present very specific references to claims made by defendants. Distinguishing between, for example, the allegedly inadequate collateralization and plaintiffs' reliance on assurances about collateralization, the

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2. Although points (f) and (g) are presented as if they alleged fraud, the core of each claim is mismanagement.

court finds that the former is an allegation of mismanagement which does not state a claim under the securities acts, whereas the latter does state a claim, since it asserts that defendants made omissions or misstatements of material facts.

Finally, the court finds that the points raised in 52(h) and (i) are allegations of misstatements or omissions, and should be allowed to remain. Accordingly, Count I is dismissed to the extent that it relies on the points raised in ¶ 52 (a), (b), (c), (f), and (g), as well as the allegations of mismanagement contained in ¶ 52 (d) and (e). All other portions of Count I raise a claim upon which relief may be granted, and will not be dismissed.

Count II is based on the same set of facts. See Complaint at ¶ 63. The court will therefore dismiss that count to the extent that it relies on the points raised in ¶ 52 (a), (b), (c), (f), and (g), and the allegations of mismanagement contained in ¶ 52 (d) and (e).

Defendants next argue that plaintiffs' securities claims in Counts I and II are too conclusory to satisfy Rule 12 (b) (6). While this position is not without merit, this court will refrain from dismissing the action at this point, in order to allow time for discovery. The court is motivated in part by the realization that many of the facts necessary to prove or disprove these allegations are largely within the peculiar knowledge of defendants.

Defendants also seek to dismiss the § 11 claim in Count II because the complaint fails to allege that the relevant securities were traceable to a registration statement alleged to be materially false or misleading. As plaintiffs point out, the complaint alleges that the shares at issue were purchased "'during the Class Period [from] the Company's common stock pursuant to the DRISP prospectus.'" Pl. brief at 34, quoting from Complaint at ¶ 61. However, defendants note that, under the DRISP prospectus, stocks may have been purchased in the secondary market, and therefore may not have been purchased during the class period. The court finds persuasive the following language from a case raising the same issues:

> "On this pleading it is by no means certain that any of the stock purchased by plaintiffs is traceable to the

> public offerings during the Class Period. Plaintiffs need not, of course, prove that their shares are traceable to the [challenged] offerings at this early stage of the litigation. But they must allege it." Bernstein v. Crazy Eddie, Inc., 702 F. Supp. 962, 972 (E.D.N.Y. 1988), vacated in part, In re Crazy Eddie, 714 F. Supp. 1285 (E.D.N.Y. 1989).

However, at this time the court will not dismiss the § 11 claim on this basis. Instead, the court will allow plaintiffs to amend their complaint to comply with the requirements of § 11. If plaintiffs do not amend within 30 days, the court will entertain a new motion to dismiss this particular claim.

Defendants argue that the § 12 claim contained in Count II should be dismissed because defendants are not "sellers" under the meaning of § 12(2). ¶ 62 of the complaint alleges: "In connection with the sale of the Company's common stock pursuant to the DRISP prospectus, defendant UJB was the 'seller' of such stock, within the meaning of Section 12(2) of the Securities Act of 1933." However, this bare allegation is not enough. See VT Investors v. R & D Funding Corp., 733 F. Supp. 823, 839 (D.N.J. 1990). Plaintiffs must "demonstrate direct and active participation in the solicitation of the immediate sale to hold the issuer liable as a § 12(2) seller." Craftmatic at 636 (emphasis added).

Here, there is no factual allegation which specifies how UJB "directly and actively participated" in the immediate sale, so that ¶ 62 of the complaint is too conclusory under Rule 12(b)(6). Garshaman v. Universal Resources Holding, Inc., 625 F. Supp. 737, 741 (D.N.J. 1986). Plaintiffs point to the DRISP prospectus which was prepared by UJB. However, mere preparation of a prospectus, without more, does not rise to a level of direct participation in the immediate sale. The court in Craftmatic found sufficient factual allegations in the complaint to deny the motion to dismiss. Specifically, the complaint alleged

> "[e]ach of the defendants . . . either sold said securities directly to plaintiffs . . . or solicited plaintiffs . . . to buy Craftmatic common stock . . . and they . . . conspired with and aided and abetted one another in connection with the preparation of the false and misleading Prospectus and Registration Statement used in

conjunction with the sale of Craftmatic securities."

Here, plaintiffs have alleged far less.

In addition, defendants argue that the § 12(2) claim should be dismissed for failure to allege that the stocks were "'issued pursuant to the defective prospectus.'" Def. brief at 27, citing Crazy Eddie, 702 F. Supp. at 972. Plaintiff relies on its reasoning in opposition to the motion to dismiss the § 11 claim. For the same reasons, the court agrees that plaintiffs have failed to state a claim upon which relief may be granted.

However, once again the court will give plaintiffs leave to amend their complaint to comply with both requirements under § 12(2), with the proviso that the court will entertain a new motion to dismiss this particular claim if plaintiffs do not amend within 30 days.

Defendants further argue that plaintiffs' § 15 claim, contained in Count II at ¶ 68, and their § 20 claim, contained in Count I at ¶ 59, should be dismissed for failure to state a "controlling person" claim. Plaintiffs argue that they have presented sufficient factual allegations to raise this claim in ¶¶ 6, 54, and 59 of their complaint. These paragraphs refers only to the individual defendants. The claim under § 15 is asserted in Count II. Since Count II is directed only at UJB, Complaint at ¶ 61, and since there is no factual allegation to support a "controlling person" claim against UJB, the § 15 claim is dismissed.

§ 20(a) of the Security Exchange Act of 1934 states:

> "Every person who, directly or indirectly, controls any person liable under any provision of this chapter or any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable . . . ." 15 U.S.C. § 78t(a).

Defendants argue that plaintiffs "allege no facts reflecting culpable participation by any of the individual defendants . . . ." It may be true that "a mere showing of . . . status . . . does not automatically connote liability as a controlling person." Laven v. Flanagan, 695 F. Supp. 800, 808 (D.N.J. 1988). However, Laven dismissed the complaint after discovery was completed. Id. at 803.

This court finds persuasive the reasoning of In re Midlantic Corp., Civ. No. 90-1275 (DRD) (D.N.J. October 11, 1990). There, the court stated, "prior to discovery in any meaningful sense, plaintiff can hardly be able to plead the precise culpable conduct of each individual defendant." Midlantic at 22. The court also noted that this circuit "has 'given heavy consideration to the power or potential power to influence and control the activities of a person, as opposed to the actual exercise thereof.' " Id. (citing Rochez Brothers, Inc. v. Rhoades, 527 F.2d 880, 890-91 (3d Cir. 1975). Thus, the court will not dismiss plaintiffs' claim under § 20(a) at this time.

Defendants next assert that plaintiffs' state law claim of negligent misrepresentation should be dismissed. Such a claim may be brought based on business reports where the plaintiffs "should reasonably [be] foresee[n] as recipients from the company of the statements for its proper business purposes . . . ." Rosenblum v. Adler, 93 N.J. 324, 352 (1983).[3] This district has read Rosenblum as an attempt to narrow the scope of this state law claim. "The argument might be made by plaintiffs that their decision to invest was a 'business decision,' and that the audit was performed for them in the sense that accountants' audit reports are prepared, and filed under the Exchange Act, with the purpose of, among other things, keeping investors informed. To conclude on that basis alone there is a negligence cause of action for the investing public generally, however, would be a liberal reading of Rosenblum." Cammer v. Bloom, 711 F. Supp. 1264, 1298-99 (D.N.J. 1989); see also id. at 1299 n. 57. Accordingly, this court will dismiss plaintiffs' third count.[4]

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3. Defendants also argue that this claim should be dismissed under Rule 12(b)(1) if the federal claims have been dismissed. Since the court has currently declined to dismiss all the federal claims, we will not dismiss this count under Rule 12(b)(1).

4. Plaintiffs cite to Midlantic for the proposition that negligent misrepresentation can be based on investor decisions. However, that court does not appear to have been presented with the issue raised in Cammer. Rather, defendants appear to have merely argued that "plain-

(continued...)

Defendants further argue that Count IV should be dismissed, because plaintiff Chappaqua has failed to allege all the necessary elements under § 14(a) of the Security Exchange Act. § 14(a) addresses omissions or misrepresentations in proxy statements. The complaint states that defendants should have revealed

> "the utter failure of the individual defendants . . . to cause UJB to disseminate reports to the investing public and to file with the SEC documents in full compliance with the federal securities laws, and to continue to cause the Company to overstate its earnings, assets and net worth by under-reserving for loan losses by at least $50 million or more, thereby causing the Company substantial losses, . . . as alleged in Counts I-III herein." Complaint at ¶ 81.

Defendants argue that this cause of action does not allege "transaction causation" as required under § 14(a). A similar argument was rejected by this district in Midlantic, Civ. No. 90-1275 at 20. There, plaintiffs' allegation was almost identically worded to the allegation in this case. Compare Midlantic at 20 with Complaint at ¶ 81. The court stated that "[t]he harm alleged here is that corporate directors were elected on the basis of materially false or misleading proxy statements. The causation alleged is perfectly clear on the face of the Complaint." Midlantic at 20.

Defendants argue that this count should be dismissed because plaintiffs fail to allege actionable misrepresentations. In Midlantic, "[t]he foundation of the defendants' argument [was] that the information they did not disclose was either a matter of mismanagement or too speculative and predictive and therefore is not actionable. Both these issues have been disposed of by this opinion in plaintiffs' favor . . . ." Midlantic at 20. Here, this court has determined that plaintiffs' fraud claims are actionable. Following the reasoning put forth in Midlantic, the court finds that Count IV is not an appropriate target at this time for a

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4. (...continued)
tiffs failed to allege the requisite reliance." Midlantic at 24. Thus, Midlantic is not helpful in the instant action.

motion to dismiss.[5]

Rule 23.1

Defendant argues that Count V should be dismissed because plaintiffs have not made a prelitigation demand, have not pled particularized facts showing that such a demand on the board is excused, and have not made a demand on UJB's shareholders. Fed. R. Civ. Pro. 23.1. Plaintiffs argue that they are excused from the prelitigation demand requirement.

Plaintiffs assert that "'the allegations of the complaint permit the inference by the court that the directors upon whom demand would be made lack the requisite disinterestedness to determine fairly whether the corporate claim should be pursued.'" Pl. brief at 42, citing Lewis v. Curtis, 671 F.2d 779, 785 (3d Cir. 1982), cert. denied 459 U.S. 880 (1982). Plaintiffs assert that they are exempt because a majority of the board are named defendants. However, this type of argument has been rejected by the courts. See Lewis at 785. Similarly, plaintiffs' arguments for exemption presented in ¶ 98 of their complaint are too speculative. Thus, it is not sufficient to allege, without particularized facts to back up the assertion, that the board "would refuse to take action with respect to these claims because any such action would require them to sue themselves, their friends, and their business associates." See id. Similarly, plaintiffs' allegation that the board is "dominated" by co-defendant Semrod is too conclusory, as is the assertions that the board participated in the wrongdoing, that the board is "self-interested," and that the board impliedly will not exercise proper business judgment on the issues presented because it has not acted in the past. See Landy v. FDIC, 486 F.2d 139, 148 (3d Cir. 1973) ("[t]hese allegations do not supply with particularity the reasons for failing to make the demand required by Rule 23.1"), cert. denied 416 U.S. 960 (1974). Accordingly, the fifth count will be dismissed.

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5. Because this court does not dismiss Chappaqua's federal claim, defendants' arguments that Chappaqua's state law claims should be dismissed under Rule 12(b)(1) cannot stand.

BEST AVAILABLE COPY

Rule 9(b)

Defendant argues that the allegations raised in Counts I and II should be dismissed because plaintiffs have failed to plead with sufficient particularity the bases for their claims of fraud, as is required under Rule 9(b). Plaintiffs first argue that the rule does not apply to its §§ 11 and 12 claims. As noted by defendant, "[a]lthough an open issue in this Circuit, numerous courts have held that Rule 9(b) applies to claims under Sections 12 and 12 of the Securities Act where, as here, the complaint sounds in fraud." Def. brief at 12 (citation omitted). Rule 9(b) states that it is applicable to "all averments of fraud . . . ." Here, the remaining portions of plaintiffs' §§ 11 and 12 claims sound in fraud. Accordingly, Rule 9(b) applies by its clear wording.

This circuit has taken a narrow approach to Rule 9(b). "Courts must be sensitive to the fact that application of Rule 9(b) prior to discovery 'may permit sophisticated defrauders to successfully conceal the details of their fraud.'" Craftmatic, 890 F.2d at 645 (citing Christidis v. First Penn. Mortgage Trust, 717 F.2d 96, 99-100 (3d Cir. 1983).

Nonetheless, plaintiffs must present adequate pleadings to put defendants on notice of the basis of the claim. Kronfeld v. First Jersey Nat'l Bank, 638 F.2d 1454, 1463 (D.N.J. 1986). Here, plaintiffs have pled with great specificity the particular statements which are allegedly false, as well as when, where, and by whom those claims were made. Despite their assertions to the contrary, however, plaintiffs have not indicated with sufficient particularity how those statements are false. Christidis is instructive. There, the court dismissed an action on the basis of Rule 9(b) because the complaint did not set out the method and manner in which defendants' statements were contradicted by their actions. Christidis, 717 F.2d at 99, 100. Thus, ¶ 52(d) alleges that UJB's loans "were not adequately collateralized or secure, contrary to defendants representations . . ." without indicating how those loans were not adequately collateralized. In ¶ 52(h), plaintiffs do not indicate how "defendants failed to disclose the full truth regarding UJB's problems loans and lack of controls." The other

remaining claims in Counts I and II are similarly pled without sufficient particularity.

The Third Circuit tends to relax the application of Rule 9(b) "when factual information is peculiarly within the defendant's knowledge or control." Craftmatic at 645. "Particularly in cases of corporate fraud, plaintiffs cannot be expected to have personal knowledge of the details of corporate internal affairs." Id. However, as Craftmatic noted, "pleaders must allege that the necessary information lies within defendants' control, and their allegations must be accompanied by a statement of the facts upon which the allegations are based." Id. Here, such pleadings are lacking.

In keeping with the rest of this opinion, however, this court will give plaintiffs the opportunity to amend their complaint in order to comply with the requirements of Rule 9(b), especially in light of the fact that discovery is still ongoing. Once again, plaintiffs will have 30 days in which to submit their amended complaint, and the court will consider a motion to dismiss if plaintiffs fail to comply with this deadline.

For the reasons presented, defendants' motion to dismiss will be granted in part and denied in part. Further, plaintiffs are instructed to amend their complaint in order to comply with this court's instructions. The court orders counsel for defendants to submit a proposed order consistent with this opinion no later than Wednesday, January 30, 1991.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 91-5153

IRWIN SHAPIRO, on behalf of himself
and all others similarly situated

v.

UJB FINANCIAL CORP.;
T. JOSEPH SEMROD; and
JOHN R. HAGGERTY

Irwin Shapiro, Robert Bassman,
Jerome Katz, Norman Salsitz,
Jean Lee, Executrix of the
Estate of Calvin Lee, and
Chappaqua Family Trust

Appellants

(D.C. Civ. No. 90-01569)

SUR PETITION FOR REHEARING

Present: SLOVITER, Chief Judge, BECKER,
STAPLETON, MANSMANN, HUTCHINSON, SCIRICA,
COWEN, NYGAARD, ALITO and ROTH, Circuit Judges,
and VanARTSDALEN*, District Judge

The petition for rehearing filed by appellees in the above-entitled case having been submitted to the judges

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* As to panel rehearing only.

who participated in the decision of this Court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular service not having voted for rehearing, the petition for rehearing by the panel and the Court in banc, is denied.

BY THE COURT,

_____
Circuit Judge

Dated: July 7, 1992

No. 92-326

AUG 12 1992

IN THE

Supreme Court of the United States

October Term, 1992

UJB FINANCIAL CORP., et al.,

Petitioners,

against

IRWIN SHAPIRO, ROBERT BASSMAN, JEROME KATZ, NORMAN SALSITZ, JEAN LEE, and CHAPPAQUA FAMILY TRUST,

Respondents.

PETITIONERS' APPENDIX II

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BETH J. JACOBWITZ

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August 12, 1992

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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

----------x

IN RE CHASE MANHATTAN CORPORATION SECURITIES LITIGATION

90 Civ. 6092 (LMM)
MEMORANDUM AND ORDER

----------x

McKENNA, District Judge:

Defendants move to dismiss the consolidated complaint pursuant to Rules 12(b)(6) and 9(b) of the Federal Rules of Civil Procedure. For the reasons set forth below, the motion is denied.

Background

This case is a class action (not yet certified) on behalf of all persons who purchased common stock of Chase Manhattan Corporation between September 20, 1989 and September 21, 1990, claiming that the defendants, namely Chase Manhattan Corporation and various individuals alleged to be "controlling persons" of Chase, violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 by misrepresenting Chase's true financial condition and operations throughout the aforementioned one year period. For purposes of this Memorandum and Order the facts as alleged in the Complaint are accepted as true. See Frasier v. General Elec. Co., 930 F.2d 1004, 1007 (2d Cir. 1991) ("In ruling on a motion to dismiss for failure to state a claim upon which relief may be granted, the court is required to accept the material facts alleged in the complaint as true.") (citing Cooper v. Pate, 378 U.S. 546 (1964)). Additionally, motions to dismiss for failure to state a claim may not be granted "unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." Frasier, supra (quoting Conley v. Gibson, 355 U.S. 41, 45-46 (1957)).

Defendant's Rule 12(b)(6) Motion

Defendants move to dismiss plaintiffs' Section 10(b) claim for failure to state a claim under Fed. R. Civ. P. 12(b)(6). To make out a claim under Section 10(b) and

Rule 10b-5,

> a plaintiff must demonstrate the existence of six elements. First, there must be a misstatement or omission by the defendant. Second, such misstatement or omission must be as to a material fact. Third, plaintiff must have relied on the misstatement or omission. Fourth, it must be shown that defendant acted with scienter. Fifth, the misstatement or omission must have been made in connection with the purchase or sale of securities. Finally, plaintiff must have suffered damage as a result of the misstatement or omission.

Breard v. Sachnoff & Weaver, Ltd., Nos. 89 Civ. 7719 (LBS) and 90 Civ. 3011 (LBS) (S.D.N.Y. January 9, 1991) (footnote omitted).

Defendants assert that the complaint is fatally flawed with respect to the fourth requirement, scienter, because "a fair reading of the complaint discloses at most the typical problems faced by virtually all banks during the current recession." Defendant's Memorandum of Law at 32. If the complaint alleged nothing more than mismanagement or a lack of foresight by defendants then dismissal would be warranted, but it is clear that knowing misrepresentations or omissions regarding the bank's financial condition do give rise to claims under Section 10(b). In Re First Fidelity Bancorporation Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶ 95,299 (D.N.J. Nov. 13, 1989). In the present case the consolidated complaint sets forth throughout its 122 paragraphs numerous statements made by defendants concerning Chase's financial controls, its continuing ability to pay dividends, the strength of its core lending market, and its expected financial performance, all of which plaintiffs allege were materially false and misleading in light of facts known or recklessly disregarded by defendants about Chase's finances. This satisfies the requirement that scienter be affirmatively pleaded, and the motion to dismiss pursuant to Rule 12(b)(6) is accordingly denied.

Defendants' Rule 9(b) Motion

Defendants also move to dismiss the complaint pursuant to Rule 9(b)[1] for failure to plead fraud with sufficient particularity. Their initial argument in this respect is that plaintiffs' pleadings allege no more than "fraud by hindsight." Defendants' principal Second Circuit support for this position is Denny v. Barber, 576 F.2d 465 (1978), where the court upheld the dismissal of a class action against Chase, among others, on the grounds that "plaintiff has simply seized upon disclosures made in later annual reports and alleged that they should have been made in earlier ones," id. at 470, and that the amended complaint did not specify which statements by the defendants were knowingly false. Id. at 469. As noted in the Rule 12(b)(6) discussion above, however, the complaint in this case makes no secret of precisely which statements by defendants the plaintiffs believe to have been knowingly false. Furthermore, knowing misrepresentations regarding a bank's condition and practices are sufficient to support a claim for securities fraud. See Nicholas v. Poughkeepsie Savings Bank/FSB, Fed. Sec. L. Rep. (CCH) ¶ 95,606 (S.D.N.Y. Sept. 27, 1990). The particularity requirement of Rule 9(b) requires only that the plaintiffs "identify who made the misstatements, the occasions on which these were made and the content of the misstatements." Yoder v. Orthomolecular Nutrition Inst., Inc., 751 F.2d 555, 561 (2d Cir. 1985) (citing Zerman v. Ball, 735 F.2d 15, 22 (2d Cir. 1984). The complaint must be read "generously, and all inferences should be drawn in favor of the pleader." Cosmas v. Hassett, 886 F.2d 8, 11 (2d Cir. 1989). The rule does not, for example, require that, prior to discovery, a plaintiff must quantify with precision the amount by which loan reserves were deficient. See Nicholas, supra. Plaintiffs have adequately complied with the requirement of particularity.

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[1]Fed. R. Civ. P. 9(b) states:

In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally.

Defendants further assert that "[i]n general, Rule 9(b) does not permit allegations of fraud to be based upon information and belief." Defendants' Memorandum of Law at 17. While this proposition, read in isolation, is correct, allegations of fraud may be based on information and belief "when facts are peculiarly within the opposing party's knowledge" and the complaint adduces "specific facts supporting a strong inference of fraud." Wexner v. First Manhattan Co., 902 F.2d 169, 172 (2d Cir. 1990). Plaintiff's allegations are based upon defendants' SEC filings, annual reports, public statements, a story in the American Banker, and defendants' admissions in Chase's Third Quarter 1990 10-Q, all of which provided a sufficient factual underpinning for the complaint, which is therefore properly based upon information and belief. See, Cosmas, supra (reversing dismissal of a securities fraud complaint based on the company's 10-K filings, press releases regarding the company's financial condition, and a statement by the company's CEO in Forbes magazine); In Re Pfizer, Inc. Securities Litigation, Fed. Sec. L. Rep. ¶ 95,710 (S.D.N.Y. Dec. 21, 1990) (denying motion to dismiss under Rule 9(b) allegations based on congressional reports, U.S. Department of Housing and Urban Development pamphlets, and testimony in state court proceedings).

The remaining portion of Rule 9(b) states that "[m]alice, intent, knowledge and other condition of mind of a person may be averred generally." The facts alleged, as discussed above, do give rise to a strong inference that the individual defendants, as senior officers of Chase, had knowledge of Chase's true financial condition at the time that the allegedly false statements were made. This is all that is required to satisfy the scienter requirement. Cosmas, supra, at 13 ("To satisfy the scienter requirement, a plaintiff need not allege facts which show the defendants had a motive for committing fraud, so long as the plaintiff, as Cosmas does here, adequately identifies circumstances indicating conscious behavior by the defendants.") (citing Beck v. Manufacturers Hanover Trust Co., 820 F.2d 46, 50 (2d Cir. 1987), cert. denied, 484 U.S. 1005, overruled on other grounds, United States v. Indelicato, 865 F.2d 1370 (2d Cir. 1989) (en banc)). Nevertheless, the complaint, at paragraphs 14 and 42, does establish a motive for the individual

defendants to keep loss reserves at a minimum, as this would "increase [Chase's] net income and thereby increases compensation paid [to the individual defendants] under the Management Incentive Plan." Complaint at ¶ 42.[2]

In sum, the requirements of Rule 9(b) have been met and defendants' motion to dismiss is denied.

The Section 20(a) Claim

Defendants also move to dismiss the claim under Section 20(a) of the Securities Exchange Act of 1934. Because defendants only ground for the motion is plaintiffs' failure to state a claim under Section 10(b), See Defendants' Memorandum of Law at 34-35, the motion is denied, for the reasons stated above.

H. J. Kalikow & Co., Inc. ("Kalikow") and Price Waterhouse seek permission to file motions to quash deposition subpoenas duces tecum served upon them, as witnesses, by plaintiffs. Permission to file such motions granted. The motions are to be made to Magistrate Judge Lee, to whom this case has been assigned for pretrial supervision, including discovery. The subpoenas addressed to Kalikow and Price Waterhouse are stayed pending determination of such motions by the Magistrate Judge.

Dated: New York, New York
August 1, 1991

SO ORDERED.

LAWRENCE M. McKENNA
U.S.D.J.

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[2]Defendants argue that "[t]here is no allegation, however, that any of the individual defendants actually received greater compensation than he would have otherwise as a result of any overstatement of Chase's earnings...." Although the scienter requirement is met without a showing of motive, it should be noted that making plaintiff's quantify defendants' gains prior to discovery would run contrary to the command in Cosmas, supra, that complaints be read generously under Rule 9(b). See also Nicholas, supra, where the court did not require the pleadings to specify the amount by which loan reserves were understated.

On Appeal from the United States District Court
For the Western District of Pennsylvania
(D.C. Civil Action No. 90-00639)
District Judge: Honorable William L. Standish

Argued May 11, 1992

BEFORE: STAPLETON, ALITO, and ALDISERT,
Circuit Judges,

JUDGMENT ORDER

After consideration of the contentions raised by appellants, it is

ORDERED AND ADJUDGED that the judgment of the district court be and is hereby affirmed essentially for the reasons set forth in the opinions of Magistrate Judge Ila Joanne Sensenich dated June 12, 1991 and September 6, 1991, which were adopted by the District Court.

Costs taxed against appellants.

By the Court,

Circuit Judge

ATTEST:

Sally Mrves, Clerk

DATED: May 20, 1992

IN THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF PENNSYLVANIA

JOHN PAUL DECKER, individually and on behalf of all others similarly situated, Plaintiff	)	
vs.	)	Civil Action No. 90-639
LANDMARK SAVINGS ASSOCIATION, J. RICHARD ESHLEMAN, JOHN A. FORBES, TIMOTHY K. ZIMMERMAN, RICHARD E. KNAPP, RALPH H. BURT, ROBERT F. GALL, WALTER C. LANGERMAN, DAVID L. LLOYD, DENNIS N. MORR, PAUL A NEELY, PATRICIA P. OLIVO, W. EDWARD SELL, and ROBERT K. WAGNER, Defendants	)	Judge William L. Standish/ Magistrate Judge Sensenich
CARL O. BRUNING, JR., on behalf of himself and all others similarly situated, Plaintiffs	)	
vs.	)	Civil Action No. 90-1027
LANDMARK SAVINGS ASSOCIATION, J. RICHARD ESHLEMAN, JOHN A. FORBES, TIMOTHY K. ZIMMERMAN, RICHARD E. KNAPP, RALPH H. BURT, ROBERT F. GALL, WALTER C. LANGERMAN, DAVID L. LLOYD, DENNIS N. MORR, PAUL A NEELY, PATRICIA P. OLIVO, W. EDWARD SELL, and ROBERT K. WAGNER, Defendants	)	Judge William L. Standish/ Magistrate Judge Sensenich

MEMORANDUM ORDER

On April 25, 1990, this case was referred to Chief United States Magistrate Judge Ila Jeanne Sensenich for pretrial proceedings in accordance with the Magistrates Act, 28 U.S.C. Section 636(b)(1)(A) and (B), and Rules 3 and 4 of the Local Rules for Magistrates.

The magistrate judge's report and recommendation, filed on June 12, 1991, recommended that defendants' motion to dismiss be granted. The parties were allowed ten (10) days from the date of service to file objections. Service was made on all parties and objections were filed by plaintiff on June 21, 1991. Defendants filed a response to the plaintiff's objections on July 3, 1991. On September 16, 1991, a supplemental report and recommendation was filed recommending that defendants' motion to dismiss be granted and that plaintiff's motion for leave to amend their consolidated class action complaint be denied. The plaintiffs filed objections to the supplemental report and recommendation on September 26, 1991, and defendants' filed a response to the plaintiffs' objections on October 11, 1991. After de novo review of the pleadings and documents in the case, together with the report and recommendation, supplemental report and recommendation, and objections thereto, the following order is entered:

AND NOW, this 23 day of October, 1991;

IT IS HEREBY ORDERED that defendants' motion to dismiss is granted and that plaintiffs' motion for leave to amend their consolidated class action complaint is denied.

The report and recommendation of Chief Magistrate Judge Sensenich, dated June 12, 1991, and the supplemental report and recommendation dated September 16, 1991, are adopted as the opinion of the court.

WILLIAM L. STANDISH
United States District Judge

cc: Ila Jeanne Sensenich
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IN THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF PENNSYLVANIA

JOHN PAUL DECKER, individually and on behalf of all others similarly situated, Plaintiff	)	
vs.	)	Civil Action No. 90-639
LANDMARK SAVINGS ASSOCIATION, J. RICHARD ESHLEMAN, JOHN A. FORBES, TIMOTHY K. ZIMMERMAN, RICHARD E. KNAPP, RALPH H. BURT, ROBERT F. GALL, WALTER C. LANGERMAN, DAVID L. LLOYD, DENNIS N. MORR, PAUL A. NEELY, PATRICIA P. OLIVO, W. EDWARD SELL, and ROBERT K. WAGNER, Defendants	)	Judge William L. Standish/ Magistrate Judge Sensenich
CARL O. BRUNING, JR., on behalf of himself and all others similarly situated, Plaintiffs	)	
vs.	)	Civil Action No. 90-1027
LANDMARK SAVINGS ASSOCIATION, J. RICHARD ESHLEMAN, JOHN A. FORBES, TIMOTHY K. ZIMMERMAN, RICHARD E. KNAPP, RALPH H. BURT, ROBERT F. GALL, WALTER C. LANGERMAN, DAVID L. LLOYD, DENNIS N. MORR, PAUL A NEELY, PATRICIA P. OLIVO, W. EDWARD SELL, and ROBERT K. WAGNER, Defendants	)	Judge William L. Standish/ Magistrate Judge Sensenich

MAGISTRATE JUDGE'S REPORT AND RECOMMENDATION

I. RECOMMENDATION

It is recommended that defendants' motion to dismiss be granted and that plaintiffs' motion for leave to amend their consolidated class action complaint be denied.

II. REPORT

On June 12, 1991, a report and recommendation was filed recommending that defendants' motion to dismiss be granted. Objections were filed by plaintiffs and subsequently they asked the court to consider the recent Supreme Court decision, Virginia Banksharers, Inc. v. Sandberg, ___ U.S. ___, ___ S.Ct. ___ (June 27, 1991), and deny defendants' motion to dismiss. Therefore an order was entered on July 12, 1991, requiring the parties to file briefs by July 26, 1991, addressing the applicability of Virginia Banksharers to this case. Both parties filed briefs and on August 9, 1991, plaintiffs filed a motion for leave to amend their complaint.

Virginia Banksharers does not help plaintiffs. In that case the court was considering a claim for damages pursuant to Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. Section 78(n)(a), to which Rule 9(b) does not apply. Further, in this case plaintiffs' complaint does not reveal the factual basis for plaintiffs' conclusions that defendants' challenged statements were intentionally false and misleading. Therefore, it is again recommended that defendants' motion to dismiss be granted.

Plaintiffs seek leave to amend their consolidated class action complaint for the second time. Their first amendment was in response to defendants' first motion to dismiss. Plaintiffs' proposed amended consolidated class action complaint does not cure the deficiencies of the first amended consolidated class action complaint. It does not allege specific facts in support of their conclusion that defendants intentionally made material misrepresentations about Landmark's commercial business and residential loans and Landmark's financial condition. Therefore, it is recommended that plaintiffs' motion for leave to amend their consolidated class action complaint be denied.

In accordance with the Magistrates Act, 28 U.S.C. Section 636(b)(1)(B) and (C), and Rule 4 of the Local Rules for Magistrates, the parties are allowed ten (10) days

from the date of service to file objections to this report and recommendation.

ILA JEANNE SENSENICH
Chief U.S. Magistrate Judge

Dated: September 16, 1991

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IN THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF PENNSYLVANIA

JOHN PAUL DECKER, individually and on behalf of all others similarly situated, Plaintiff	)	
vs.	)	Civil Action No. 90-639
LANDMARK SAVINGS ASSOCIATION, J. RICHARD ESHLEMAN, JOHN A. FORBES, TIMOTHY K. ZIMMERMAN, RICHARD E. KNAPP, RALPH H. BURT, ROBERT F. GALL, WALTER C. LANGERMAN, DAVID L. LLOYD, DENNIS N. MORR, PAUL A NEELY, PATRICIA P. OLIVO, W. EDWARD SELL, and ROBERT K. WAGNER, Defendants	)	Judge William L. Standish/ Magistrate Judge Sensenich

CARL O. BRUNING, JR., on behalf of himself and all others similarly situated, Plaintiffs	)	
vs.	)	Civil Action No. 90-1027
LANDMARK SAVINGS ASSOCIATION, J. RICHARD ESHLEMAN, JOHN A. FORBES, TIMOTHY K. ZIMMERMAN, RICHARD E. KNAPP, RALPH H. BURT, ROBERT F. GALL, WALTER C. LANGERMAN, DAVID L. LLOYD, DENNIS N. MORR, PAUL A. NEELY, PATRICIA P. OLIVO, W. EDWARD SELL, and ROBERT K. WAGNER, Defendants	)	Judge William L. Standish/ Magistrate Judge Sensenich

MAGISTRATE JUDGE'S REPORT AND RECOMMENDATION

I. RECOMMENDATION

It is recommended that defendants' motion to dismiss be granted.

II. REPORT

These are consolidated securities actions against Landmark Savings Association ("Landmark") and certain of its officers and directors, filed on behalf of all persons who purchased Landmark common stock during the period of April 20, 1987 through March 20, 1991.[1] The consolidated amended class action complaint alleges violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 ("Act"), 15 U.S.C. Section 78j(b) and Section 78t(a) ("Section 10(b)" and "Section 20(a)" respectively), and Sec. Rule 10b-5, 17 C.F.R. Section 240.10b-5 ("Rule 10b-5"), in that defendants intentionally concealed Landmark's true financial condition in order to inflate the price of its stock. Plaintiffs amended their complaint in response to defendants' first motion to dismiss. Defendants then filed a motion to dismiss plaintiffs' amended complaint pursuant to Federal Rules of Civil Procedure 12(b)(6) and 9(b) claiming that the complaint fails to state a claim upon which relief can be granted and fails to plead fraud with particularity.

This case appears to be based on the fact that the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) which was signed on August 9, 1989, and became effective on December 7, 1989, imposed new capital standards on savings associations like Landmark. When the new Act went into effect Landmark did not meet all the capital standards imposed by the Act. In addition, the Act required Landmark to change the manner in which it accounted for goodwill on its books. The complaint reveals that defendants notified Landmark's shareholders and the public of their concern about satisfying the requirements of FIRREA before it passed and that they announced that Landmark would not be in compliance with the act even before the effective date of the Act. Mismanagement does not violate the Securities Exchange Act and plaintiffs have not alleged facts sufficient to support a finding of fraud on the part of the defendants.

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1. Although the parties refer to this action as a class action, plaintiffs have not yet filed a motion for class certification.

Plaintiffs allege that during the class period defendants made material misrepresentations in the annual reports and in various written statements about Landmark's capitalization, earnings, assets and management controls. Then, in March of 1990, defendants suddenly announced a write-off of over $42,000,000.00 attributable to the reclassification of assets and a substantial increase in its non performing loans.

The standard for considering a motion to dismiss under Rule 12(b)(6) is that "factual allegations of the complaint are to be accepted as true and the complaint should be dismissed only if it appears to a certainty that no relief could be granted under any set of facts which could be proved. Reasonable factual inferences will be drawn to aid the pleader." D.P. enterprises v. Bucks County Community College, 725 F.2d 943, 944 (3 Cir. 1984).

Under Rule 9(b)[2] allegations of fraud must be plead with particularity. In Christidis v. First Pennsylvania Mortgage Trust, 717 F.2d 96 (3d Cir. 1983), the court held that the district court had properly dismissed prior to discovery for failure to allege fraud with the specificity required by Rule 9(b). The plaintiff was seeking money damages on behalf of a class of purchasers of shares of the trust. The complaint alleged that the defendants' financial statement understated the reserves which the Trust should have accrued for bad debts in violation of the anti-fraud provisions of several federal securities acts. The Court of Appeals discussed the history of Rule 9(b) and the requirements for pleading fraud under the rule.

> Historically, Rule 9(b) is derived from English Common Law Practice. . . . As Judge Clark Noted:
>
> > [it has been the rule under both Common Law and Code Pleading that allegations

---

2. "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge and other condition of mind of a person may be averred generally." Federal Rule of Civil Procedure 9(b).

> of fraud must be made with a great degree of particularity. Thus, it is said that the elements of fraud in an action for false representation are five, as follows:
>
> (1) a specific false representation of material facts;
>
> (2) knowledge by the person who made it of its falsity;
>
> (3) ignorance of its falsity by the person to whom it was made;
>
> (4) the intention that it should be acted upon; and
>
> (5) the plaintiff acted upon it to his damage.
>
> C. Clark, Code Pleading Section 48, at 312 (2d Ed. 1947). It is the identification of these elements of a fraud claim which the first sentence of Rule 9(b) requires. The rule applies not only to fraud actions under federal statutes, but to fraud claims based on state law. In applying the first sentence of Rule 9(b) courts must be sensitive to the fact that its application, prior to discovery, may permit sophisticated defrauders to successfully conceal the details of their fraud. Moreover, in applying the rule, focusing exclusively on its "particularity" language "is too narrow an approach and fails to take account of the general simplicity and flexibility contemplated by the rules."

Id. at p. 99-100. In that case the court held that the complaint did not satisfy the requirements of Rule 9(b) because it did not disclose the manner in which, in establishing reserves for bad debts in the financial statements relied on, the defendants had knowingly departed from reasonable accounting practices. The defendant's estimates could be fraudulent only if, when they were established, the responsible parties knew or should have known that they were derived in a manner inconsistent with reasonable accounting practices.

The sections of the Act which plaintiffs maintain defendants have violated provide as follows:

> Section 78j. Manipulative and Deceptive Devices. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—. . . (b) to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.
>
> Section 78t. Liability of Controlling Persons.
>
> A. Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation of cause of action.

In Peil v. Speiser, 806 F.2d 1154 (3d Cir. 1986), the court noted that a plaintiff bringing an action under Section 78j must establish six elements which had traditionally been required under the common law tort action of deceit.

> To prevail in such an action, a plaintiff had to establish six elements: (1) a false representation of (2) a material (3) fact; (4) defendant's knowledge of its falsity and his intention that plaintiff rely on it; (5) the plaintiff's reasonable reliance thereon; and (6) his resultant loss.

Id. at p.1160.

In Vt. Investors v. R&D Funding Corporation, 733 F. Supp. 823, 828 (D.N.J. 1990), the court identified the sig-

nificant elements the plaintiff must allege in a complaint to maintain a Rule 10b-5[3] violation.

> In this jurisdiction the significant elements of a Rule 10b-5 violation are (1) a material misrepresentation; (2) a purchase or sale of a security; (3) scienter on the part of the defendant who made the misrepresentation; and (4) that the misrepresentation be made "in connection with" the purchase or sale of a security. Angelastro v. Prudential-Bache Securities, Inc., 764 F.2d 939, 942 (3d Cir.), Cert. denied, 474 U.S. 935, 106 S.Ct. 267, 88 L.Ed.2d 274 (1985).

In Craftmatic Securities Litigation v. Kraftsow, 890 F.2d 628 (3d Cir. 1990), a class action in which plaintiff John P. Decker was a named plaintiff, the court affirmed dismissal of the complaint as to some claims, reversed dismissal as to others, and gave the plaintiffs an opportunity to amend as to others. The plaintiffs were a class comprised of all persons who had purchased stock during the period from March 5, 1986 to June 11, 1987. They alleged that they purchased the securities based on documents that allegedly misrepresented or omitted material information. The court noted that in Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977), the Supreme Court held that acts of corporate mismanagement do not violate Section 10(b) or Rule 10b-5 in the absence of deception, misrepresentation, or nondisclosure. Referring to Santa Fe the court stated:

> [A] breach of fiduciary duty, unaccompanied by

---

3. Employment of manipulative and deceptive devices. It shall unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

misrepresentation, nondisclosure, or deception, does not violate the statute or the rule . . . Congress did not intend § 10(b) to regulate 'transactions which constitute no more than internal corporate mismanagement.'"

638. The court added:

> [W]e must be alert to ensure that the purpose of Santa Fe is not undermined by 'artful legal draftsmanship'; claims essentially grounded on corporate mismanagement are not cognizable under federal law.

638-639. Since the prospectus provided an accurate and reasonably detailed account of past operations and complete financial statements, the concerns underlying the Securities Act were not implicated simply because management had failed to characterize:

(1) Its new product research and other studies as meaningless (¶ 49(f) of the complaint).

(2) Itself is unfocused and unable to manage its businesses (¶ 49(i) of the complaint).

(3) Its costs as "out of control" and its costs controls as ineffective (¶ 49(j) of the complaint).

(4) Its financial reporting and accounting controls as inadequate and ineffective (¶ 49(k) of the complaint).

(5) Its "information systems" as "wholly inadequate" (¶ 49(l) of the complaint).

Therefore the court affirmed its dismissal of these claims.

The court reversed the dismissal of plaintiffs' allegations that the prospectus failed to disclose facts material to the evaluation of the offered security such as:

(1) The success of the advertising, promotion, and marketing program depended on deceptive, illegal practices (¶ 49(a) of the complaint).

(2) The program violated various consumer protection laws and consent orders entered into

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between Craftmatic and federal and state governments (¶ 49(b) of the complaint).

(3) The program resulted in abnormally high level of consumer complaints (¶ 49(h) of the complaint).

(4) Despite its entry into consent orders resulting from the company's advertising and marketing activities, Craftmatic misrepresented its chairs as "custom-fitted" (¶ 49(n) of the complaint).

The court found that if the plaintiffs could prove these facts, a jury could conclude that the prospectus failed to disclose material facts necessary to make the disclosed material statements not misleading in violation of Sections 11(a), 12(2) and Rule 10b-5.

The court found that the following allegedly omitted predictions would have been sufficiently speculative and unreliable to be immaterial as a matter of law and affirmed their dismissal:

(1) The documents were materially false and misleading in that they failed to disclose that the success of Craftmatic's advertising and marketing program was dependent on deceptive, illegal sales practices that would and did result in serious charges being brought against Craftmatic. (¶ 49(a) of the complaint).

(2) The documents were materially false and misleading in that they failed to disclose that Craftmatic's rapid expansion program entailed an unusual and extremely high risk of failure, particularly in connection with its development of new product lines and its acquisition and/or resale of distributorships, and that, in embarking upon its abnormally speculative venture, the company was essentially gambling with its profitability. (¶ 49(d) of the complaint).

(3) The documents were materially false and misleading in that they failed to disclose that

Craftmatic's application of the advertising and marketing strategies of its core bed and chair business to new product lines entailed enormous costs that would far outstrip the revenues generated by the new product lines and hurt the company's profitability. (¶ 49(e) of the complaint).

(4) The documents were materially false and misleading in that they failed to disclose that in order to report increases in total net sales, Craftmatic required an ever increasing number of distributorships in uncertain marketing territories, as well as commensurate increases in promotional costs and expensive print and electronic media advertising expenditures, without which Craftmatic's total net sales would stagnate or decline. (¶ 49(g) of the complaint).

(5) The documents were materially false and misleading in that they failed to disclose that Craftmatic's rate of growth in its core bed and chair business was not sustainable. (¶ 49(m) of the complaint).

(6) The documents were materially false and misleading in that they failed to disclose that Craftmatic's water purification and security shutter product lines were not amenable to being marketed successfully by the in-home direct sales techniques and were developed for the company's core bed and chair business. (¶ 49(p) of the complaint).

The court recognized that application of Rule 9(b) prior to discovery "may permit sophisticated defrauders to successfully conceal the details of their fraud," (645). The court noted that Rule 9(b) had been relaxed when factual information was peculiarly within the defendant's knowledge or control. However, the court stated, "Even under a non restrictive application of the rule, pleaders must allege that the necessary information lies within defendant's control, and their allegations must be accompanied by a statement of the facts upon which the allegations are based." (645). The

court added:

> However, plaintiffs must accompany their allegations with facts indicating why the charges against defendants are not baseless and why additional information lies exclusively within defendant's control.

Id. at 646.

Plaintiffs' claims that defendants artificially inflated Landmark's share price fit into two general categories. First, they claim that defendants concealed and failed to disclose that they made increasingly risky commercial business and residential loans for which they failed adequately to reserve against loss. Second, they allege that defendants concealed Landmark's precarious financial condition by exaggerating its earnings, assets and net worth and concealing the fact that it was undercapitalized.

Paragraphs 31 and 52 of the complaint address defendants' alleged concealment and failure to disclose that they made increasingly risky commercial business and residential loans for which they failed adequately to reserve against loss. Paragraph 31 alleges as follows:

> In 1986, the individual defendants caused Landmark to embark on an aggressive campaign to promote its publicly traded securities to the investing public and artificially inflate or maintain Landmark's share prices, by concealing and failing to disclose Landmark's inadequate capitalization, its risky commercial business and residential real estate loan portfolios, its precarious financial condition, and otherwise to exaggerate its earnings, assets and net worth. The campaign included Landmark's declaration of dividends, which payments were not justifiable under the circumstances. Defendant Eshleman falsely or with reckless regard for the truth touted Landmark's strong financial condition in a letter to shareholders disseminated in March, 1987:
>
> > For the first time in Landmark's history as a public company we paid a dividend to our shareholders. The dividend

> of five cents per share was declared in every quarter commencing in April of 1986. I believe the dividend symbolizes the Board's confidence in the inherent financial strength of Landmark.
>
> One of the major concerns of federal regulators is the undercapitalization of the savings and loan industry. It's a concern we at Landmark share because the stronger the industry, the more attractive our stock becomes. While this industry problem did not directly affect Landmark, we still felt that if we were to grow and be able to take advantage of further opportunities, our capital position should be enhanced.

Plaintiffs do not identify any specific information defendants allegedly concealed and failed to disclose relating to Landmark's alleged inadequate capitalization. They do not identify the way in which Landmark's commercial business and residential real estate loan portfolios were risky. They do not identify how defendants exaggerated Landmark's earnings assets and net worth. They provide no factual basis for their claim that dividend payments were not justifiable under the circumstances. These claims are similar to the claims alleged in paragraphs 49(d), (e), (q), (m) and (p) of Craftmatic, supra, which the Court of Appeals held had been properly dismissed. While these claims might support a claim of mismanagement by defendants, Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977), recognized that mismanagement is not a basis for a federal claim.

Paragraph 52 of the complaint alleges:

> Throughout the Class Period, the representations that Landmark's assets, earnings and net worth were appropriately recorded on its books and that it was adequately capitalized were false and misleading. In fact, contrary to the defendants' representations and statements, throughout the Class Period, Landmark's assets, earnings and net worth were overstated, and Landmark was under

> capitalized. Moreover, during the Class Period, defendants' zeal for expansion caused Landmark to extend imprudent and commercially unreasonably loans, for which Landmark failed to adequately reserve against loss. The balance of non-performing business loans increased by approximately 260% during the two year period, ending December 31, 1989. This increase, which constituted 44% of all non-performing loans in that period, was concentrated in five large loans which together made up 80% of total non-performing commercial business loans.

Plaintiffs allegations are broad and conclusory and lack factual support. As to plaintiffs' claim that Landmark failed to adequately reserve against loss, it is noted that in Christidis, supra, the court held that the plaintiff's claim that the defendants' financial statements understated the reserves which the trust should have accrued for bad dates did not sufficiently allege fraud with the specificity required by Rule 9(b) and was properly dismissed.

In DiLeo v. Ernst & Young, 901 F.2d 624 (7th Cir. 1990), the plaintiffs brought an action against Continental Illinois Bank's accounting firm. The plaintiffs contended that the accountants violated the securities laws by certifying fraudulent financial statements of the bank and by aiding and abetting the bank's violations of the securities laws. Although this action was not against the bank directly, the court discussed whether or not the bank's financial trouble in the 1980's was caused by fraudulent action. The court stated that the gist of the plaintiffs' complaint was that the bank had failed to establish sufficient reserves to cover the ever larger volumes of non-performing loans. The court stated that the securities law do not protect investors against reverses and that the plaintiffs had failed to show how the failure to increase the reserves amounted to "fraud." The court referred to the complaint to show how it failed to meet the specificity requirements of Rule 9(b):

> Paragraph 46(c) is the closest the complaint approaches to specificity:
>
> (i) At Annual Report page 22, provisions for credit losses were stated at $492 million which

failed to reflect the material amounts of credits for which reserves should have been taken, in additional amounts of at least $600 million.

(ii) At page 22, net credit losses of $393.2 million were materially understated by approximately $4 billion in bad loans.

(iii) At page 22, nonperforming loans were reported at approximately $1.9 billion which materially understated the amount of loans which were not performing or which had been restructured to give the illusion that they were currently meeting obligation. . .

Id. at p. 626. The court found that the complaint did not include a single, concrete example of fraud and failed to state who, what, when, where, and how as required by Rule 9(b). The court further stated:

> The story in this complaint is familiar in securities litigation. At one time the firm bathes itself in a favorable light. Later the firm discloses that things are less rosy. The plaintiff contends that the difference must be attributable to fraud. "Must be" is the critical phrase, for the complaint offers no information other than the differences between the two statements of the firm's condition. Because only a fraction of financial deteriorations reflects fraud, plaintiffs may not proffer the different financial statements and rest. Investors must point to some facts suggesting that the difference is attributable to fraud.

Id. at p. 627.

Paragraph 53 of plaintiff's amended complaint alleges the following:

> Landmark's precarious and undisclosed financial condition placed it out of compliance with the federal capital requirements of FIRREA, and subjected it to various sanctions and penalties, including the possibility of the appointment of a conservator, the assessment of daily fines, termination of deposit insurance, and other sanctions, thereby injuring its financial operations.

This paragraph appears to allege that Landmark was subjected to the possibility of various sanctions by reason of the fact that it was not in compliance with the federal capital requirements of FIRREA. However, this paragraph does not allege any specific misrepresentation and does not sufficiently allege fraud.

Plaintiffs' remaining claims are included under the broad category of concealment of Landmark's precarious financial condition by exaggerating its earnings, assets and net worth and concealing the fact that it was undercapitalized. The claim that it was undercapitalized, as has already been noted, appears to have been based upon the fact that it did not meet the requirements for capitalization under FIRREA which went into effect on December 7, 1989. Plaintiffs have not alleged any specific facts which should have put any of the defendants on notice that Landmark was undercapitalized, other than a change in the law. The complaint actually reveals that prior to enactment of FIRREA defendants realized the new act was likely to increase Landmark's capital requirements, that action would have to be taken to attempt to comply with the Act and that the public and stockholders were so notified. In paragraph 43 of the complaint plaintiffs allege that in its Form 10Q Report for the quarter ending on March 31, 1989, which was signed by defendants Eshleman and Zimmerman, Landmark reported that its assets at March 31, 1989, represented $1.8 billion, and because of its proper capitalization it expected to "be able to comply with the new more stringent requirements" to be imposed by federal legislation. Plaintiffs allege "given what the defendants knew or should have known with respect to the 'quality' of its capitalization, such statement was either knowingly false or made with reckless disregard for the truth." Defendants were merely referring to anticipated legislation and their expectation that they would be able to comply with the new requirements. Plaintiffs fail to allege any facts supporting their conclusion that this statement was either knowingly false or made with reckless disregard for the truth. Defendant admitted they would have to take affirmative action to comply with the pending legislation.

Paragraph 44 of the amended complaint alleges that in

its Form 10Q report for the quarter ending on June 30, 1989, which was signed by defendants Eshleman and Zimmerman, Landmark reported that its assets at June 30, 1989, represented $1.8 billion and that Landmark continued to represent falsely that it was adequately capitalized as follows:

> Landmark's regulatory capital requirements as of June 30, 1989 was approximately $50.8 million. Regulatory capital at June 30, 1989 totalled $92.5 million, exceeding the minimum regulatory capital requirement by $41.7 million.
>
> > New capital requirements currently being finalized by a Congressional conference committee will most likely significantly increase the amount of regulatory capital required for all thrift institutions. The new capital requirements are expected to be comprised of three components. Institutions would be required to maintain core capital of at least 3% of total assets, maintain tangible capital (regulatory capital less supervisory goodwill) of 1.5% of total assets, and meet a risk-based capital standard. During the past several months, Landmark has been closely monitoring the developments of the new legislation. The Association has implemented some specific measures to improve its capital position and is studying others which management believes will achieve compliance with the new capital requirements.

Plaintiffs do not challenge the actual facts and figures defendants gave in the report and do not assert contrary figures. Defendants admitted in the report that they would have to take affirmative action to comply with the pending legislation.

Plaintiffs alleges in paragraph 45 that on October 2, 1989, defendant Eshleman shocked the investment community when he publicly announced that Landmark was not in compliance with the capital requirements under FIRREA. It is noted that plaintiffs alleged the class period extended from April 20, 1987 to March 20, 1990, although the com-

plaint specifically alleges that on October 2, 1989, prior to the effective date of FIRREA, on December 7, 1989, defendant Eshleman publicly announced that Landmark would not be in compliance with the capital requirements of FIRREA.

Paragraph 46 of the amended complaint alleges that after OTS published its final rules on capital standards on November 9, 1989, Landmark announced a new "policy of moderate asset shrinkage in connection with an overall plan to meet the more stringent capital requirements included in FIRREA." Plaintiffs' complaint therefore reveals that during the class period defendants publicly announced the action they were taking to attempt to comply with the new capital requirements.

Paragraph 47 of the amended complaint alleges that on December 22, 1989 (during the class period) Landmark publicly announced it was not in compliance with the newly finalized federal capital requirements and that its non compliance could have a significant affect on dividends. Defendant Eshleman announced that while the OTS reviewed Landmark's new capital plan, new federal regulations would "restrict asset growth and payment of dividends, and the regulators could require similar restrictions in the capital plan." This allegation does not support a claim of fraud.

In paragraph 48 plaintiffs allege that defendant Eshleman revealed that Landmark's ability to pay dividends was significantly and adversely affected by its non compliance with the federal capital requirements as follows:

> We have applied for approval to continue dividend payments, although there is no assurance it will be granted or that a response will be received prior to the next regular dividend payment date.

This allegation does not support a claim of fraud.

Paragraph 49 of the amended complaint alleges that when Landmark filed its Form 10-K in March 1990 for the year ended December 31, 1989, to the market's surprise Landmark reported that its classified or problem assets totalled $25.3 million, of which $23.7 million represented assets substandard, 336,000 represented assets classified

doubtful, with the remaining $1.3 million classified loss. Plaintiffs allege that according to this report this amount "was primarily attributable to increases in non performing commercial business loans and residential real estate loans." Plaintiffs allege no facts which would support a finding of fraud.

Paragraph 50 of the amended complaint alleges that on March 20, 1990, the ending date of the alleged class, defendant Eshleman announced that Landmark would write off $42.6 million and restate its income for 1989 as a loss of $38.1 million. Plaintiffs allege that Landmark had previously reported a profit of $4.5 million or $1.90 per share for 1989. Plaintiffs allege that the write off and loss were attributable to the intangible assets carried wrongfully as good will on Landmark's books since 1982. They allege that defendant Eshleman further announced that Landmark had suspended payment of quarterly dividends. The complaint itself reveals that these actions resulted from the change in federal law as a result of FIRREA and that defendants had been given notice since March 31, 1989 of its need to take affirmative action to comply with the proposed legislation as it seemed to be developing. Plaintiffs have provided no factual basis for a finding that any of the defendants are guilty of fraud.

In paragraphs 23 and 35 of the amended complaint, plaintiffs allege that defendants improperly amortized and retained as an asset millions of dollars in purported "goodwill" which was not recoverable from operations. The section of the 1987 annual report quoted in paragraph 35 of the complaint admitted that the excess of cost over net assets acquired, or goodwill, was a challenge for Landmark. It was admitted that it was a non earning asset that forced Landmark to work harder to give its shareholders an attractive rate of return. Plaintiffs have offered no factual basis for a conclusion that prior to the effective date of FIRREA it was improper to carry "goodwill" on Landmark's books as an asset. In Christidis, supra, in affirming the dismissal of the complaint the court stated:

> [The complaint's] defect is the complete absence of any disclosure of the manner in which, in establishing reserves for bad debts in the financial

> statements relied upon, the defendants knowingly departed from reasonable account practices . . . [The reserves] could be fraudulent only if, when they were established, the responsible parties knew or should have known that they were derived in a manner inconsistent with reasonable accounting practices.

717 F.2d at 100. (Emphasis added). Plaintiffs' challenge to Landmark's treating goodwill as an asset appears to be based on the fact that it could no longer do so after the effective date of FIRREA. A change in law does not support a claim of fraud. The 1987 annual report specifically told shareholders and the public that Landmark was carrying goodwill as a non earning assets. Therefore the complaint does not allege a factual basis for a claim of fraud.

In paragraph 32 of the amended complaint plaintiffs allege:

> Spurred on by Landmark's management and the need to maximize reported profits, defendants continued to tout the quality of Landmark's assets and its strong capitalization in its Form 10-K Report in March, 1988.
>
> > Under the new regulation (published by the FHLLB on December 21, 1987, under the Competitive Equality Banking Act of 1987, Landmark's) substandard assets totalled $19.8 million . . . (Landmark) has no assets classified as doubtful or loss at December 31, 1987 and 1986.

Plaintiffs have identified no assets which they claim defendants should have classified as doubtful or loss at December 31, 1987 or 1986.

Paragraph 33 of the amended complaint alleges:

> Continuing to portray Landmark in a falsely optimistic manner, defendant Eshleman's letter to shareholders in Landmark's 1987 Annual Report, released in or about March, 1988, stated:
>
> > Landmark's earnings for 1987 were $7.1 million, or $2.90 per share, as compared

> to $5.2 million, or $2.70 per share, for 1986 . . .
>
> In keeping with our excellent operating results, Landmark paid a cash dividend on its common stock for each quarter of 1987 . . .
>
> Asset quality remained excellent and considerably better than the national average for the savings and loan industry.

Plaintiffs have alleged no facts which would establish that defendant Eshleman's letter contained known misrepresentations at the time it was made.

Paragraph 34 of the amended complaint alleges that in his letter in Landmark's 1987 Annual Report defendant Eshleman stated:

> The savings and loan industry and its well-managed institutions became blemished in 1987 by the closures of a number of thrifts and the need to recapitalize the FSLIC. For Landmark this is particularly frustrating because, as our shareholders can see, we are profitable, financially sound and have excellent potential for growth. But Landmark's stock is caught in the morass of our industry's poor image brought about by a few savings and loan failures and sensational headlines. We have been victimized by circumstances over which we have no control.

This letter would appear to give potential investors notice that Landmark was facing problems which could result in loss of stock value.

Paragraph 36 of plaintiff's amended complaint alleges:

> In his letter to Landmark's shareholders in the Landmark's 1988 Annual Report, released in or about March, 1989, Defendant Eshleman falsely advised shareholders that Landmark had celebrated its "best years ever, in spite of the crises that was rocking the thrift industry" and that Landmark was "rock solid and well positioned for the future."

Plaintiffs have alleged no facts which would provide a basis for finding these statements to have been untrue when they were made. Plaintiffs allege in paragraph 37 of the amended complaint that:

> Landmark's 1988 Annual Report further represented falsely that Landmark was in healthy economic condition and well managed:
>
> > The most gratifying aspect of 1988 is that earnings were the highest since the Association's inception. 1988 also represented the fourth consecutive year of improved earnings. These results were accomplished by doing the things a well-managed financial institution should do: increase deposits, make quality loans, reduce exposure to escalating interest rates and control expenses. (Annual Report, p. 20).

Plaintiffs have alleged no facts which would provide a basis for finding that any of the statements in this annual report were known to be false when they were made.

Paragraphs 38 and 52 of the amended complaint allege that in the 1988 Annual Report and throughout the class period, defendants represented that Landmark's management had in place reasonable internal control systems with respect to the recording of transactions on Landmark's books and that these representations were false and misleading. In paragraph 52 of the amended complaint, plaintiffs allege:

> In fact, contrary to the defendants' representations and statements, throughout the Class Period, Landmark's assets, earnings and net worth were overstated, and Landmark was under capitalized. Moreover, during the Class Period, defendants' zeal for expansion caused Landmark to extend imprudent and commercially unreasonable loans, for which Landmark failed to adequately reserve against loss. The balance of non-performing business loans increased by approximately 260% dur-

> ing the two year period, ending December 31, 1989. This increase, which constituted 44% of all non-performing loans in that period, was concentrated in five large loans which together made up 80% of total non-performing commercial business loans.

As has already been noted, the only specific instances of Landmark's allegedly failing appropriately to record assets earnings and net worth on its books were the changes required by FIRREA. It had to stop carrying goodwill as an asset and after adoption of that act Landmark was undercapitalized. The complaint reveals that defendants had admitted these potential problems prior to the effective date of FIRREA.

In paragraph 39 of the amended complaint, plaintiffs allege:

> Furthermore, the 1988 Annual Report described Landmark's assets of $1.8 billion as of December 31, 1988, as representing an "increase of $183.3 million or 11.1% from December 31, 1987." (Annual Report, p. 24).

Plaintiffs do not challenge this statement as factually untrue at the time it was made.

Paragraph 40 of the amended complaint alleges as follows:

> In addition, the 1988 Annual Report represented the following with respect to Landmark's earnings per share and dividends per share on its common stock:

	1988	1987
Earnings	$ 3.68	$ 2.90
Dividends	.28	.20
Book Value/Share	34.59	31.58

Plaintiffs have offered no factual basis for concluding that the defendants had reason to believe the above figures were not true at the time the report was prepared.

In paragraph 41 of the amended complaint plaintiffs allege that "Defendants continued to condition the market to

believe that Landmark was maintaining regulatory capital requirements. In fact, in the 1988 Annual Reports, Landmark represented falsely that it was more than adequately capitalized." However, the section of the report plaintiffs quote merely states that Landmark had regulatory capital of $90.4 million at December 31, 1988, which exceeded the regulatory capital requirement by approximately $37.8 million. Plaintiffs have offered no factual basis for concluding that the figures defendants gave were false at the time they were given or that defendants did not have reason to believe at that time that Landmark's regulatory capital exceeded the regulatory capital requirement by approximately $37.8 million.

In paragraph 42 of the amended complaint plaintiffs allege:

> In the 1988 Annual Report, Landmark represented that it had "consistently maintained high asset quality . . ." (Annual Report, p. 27). However, at that same time, and throughout the Class Period, Landmark's list of non-performing assets was growing rapidly.

Plaintiffs have not identified the list of non-performing assets which they claim was growing rapidly at that time and the percentage of non-performing assets to other assets.

Paragraph 55 of the amended complaint, as follows, is extremely conclusory:

> Throughout the Class Period, defendants trumpeted their apparently positive operating results and their purportedly conservative banking practices while down playing their problems. Defendants issued many public statements and reports, including financial statements and other reports, releases and statements as described which were materially false and misleading in violation of Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder. The reports, release, and statements were materially false and misleading in that they failed to disclose material adverse information about the veracity of Landmark's reported assets, earnings and net worth, and its

inadequate capitalization.

Complaints alleging fraud cannot rely on notice pleading. Plaintiffs' amended compliant, which was filed in response to defendants' first motion to dismiss, does not allege a factual basis for securities fraud as required by Third Circuit law. Therefore, it is recommended that defendants' motion to dismiss be granted.

In accordance with the Magistrates Act, 28 U.S.C. Section 636(b)(1)(B) and (C), and Rule 4 of the Local Rules for Magistrates, the parties are allowed ten (10) days from the date of service to file objections to this report and recommendation.

ILA JEANNE SENSENICH
Chief U.S. Magistrate Judge

Dated: June 12, 1991

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MOTION FILED
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No. 92-267

IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

UJB FINANCIAL CORP., et al.,

Petitioners,

v.

IRWIN SHAPIRO, ROBERT BASSMAN,
JEROME KATZ, NORMAN SALSITZ,
JEAN LEE and CHAPPAQUA FAMILY TRUST,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* AND BRIEF *AMICUS CURIAE* OF DEAN WITTER REYNOLDS, INC., MORGAN STANLEY & CO. INCORPORATED, PAINEWEBBER INCORPORATED, WERTHEIM SCHRODER & CO. INCORPORATED AND THE SECURITIES INDUSTRY ASSOCIATION, IN SUPPORT OF PETITIONERS

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MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE*

Dean Witter Reynolds Inc., Morgan Stanley & Co. Incorporated, PaineWebber Incorporated and Wertheim Schroder & Co. Incorporated, registered broker-dealers engaged in the business of underwriting securities, hereby respectfully move for leave to file the attached brief as *amici curiae* in support of the Petition for Certiorari filed by UJB Financial Corp., et al. The Securities Industry Association, a trade association representing the collective interests of over 600 securities firms headquartered throughout the United States and Canada, also joins this motion.

The consent of all parties to this action for the filing of the attached *amicus curiae* brief has been requested. The consent of the attorneys for the petitioners has been obtained. The attorneys for the respondents have withheld consent.

The complaint in *Shapiro* v. *UJB Financial Corp.*, 964 F.2d 272 (3d Cir. 1992), is typical of those in dozens of cases brought since the onset of the national recession. It alleges that the bank deliberately overstated its financial condition by providing inadequate reserves for loan losses. The complaint, like others of its type, points to an increase in loan loss reserves from one reporting period to the next and alleges, with little or no factual elaboration, that the reserves established in the earlier periods were fraudulently understated.

Complaints of this type are not limited to the banking industry, nor to charges relating to loan loss reserves. Substantial numbers of analogous complaints have been filed against both issuers and underwriters of securities in the wake of disappointing performance by companies that have made public offerings of securities.

As securities industry participants highly susceptible to claims of "fraud by hindsight,"[1/] *amici* fear that if the decision below is allowed to stand, ordinary business reverses would expose issuers and

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[1/] *Denny* v. *Barber*, 576 F.2d 465, 470 (2d Cir. 1978).

underwriters to burdensome proceedings absent any evidence of, or even basis for charging, wrongdoing. Such suits would create a serious impediment to the capital-raising process which in turn would have an unwarranted and deleterious effect on the operation of the U.S. capital markets. Reversal of the Third Circuit's decision in this case is essential to maintaining a proper balance among the rights of all participants in the marketplace.

Amici seek to submit the attached brief in support of certiorari to emphasize the importance of the issues to American business and to describe the impact of the Third Circuit's decision on the capital markets.

Dated: August 19, 1992

Respectfully submitted,

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2A James W. Moore & Jo D. Lucas, *Moore's Federal Practice* ¶ 9.03[1] (1991) 7

5 Charles A. Wright & Arthur R. Miller, *Federal Practice and Procedure: Civil 2d* § 1298 (1990) 7

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INTERESTS OF *AMICI*

Dean Witter Reynolds Inc., Morgan Stanley & Co. Incorporated, PaineWebber Incorporated and Wertheim Schroder & Co. Incorporated, registered broker-dealers engaged in the business of underwriting securities, respectfully submit this brief, as *amici curiae*, in support of petitioner. The Securities Industry Association, a trade association representing the collective interests of over 600 securities firms headquartered throughout the United States and Canada, also joins this brief as *amicus curiae* in support of petitioner.

Amici are concerned that the standard set forth in this case as applicable to complaints asserting securities fraud will have an unwarranted and deleterious effect on the operation of the U.S. capital markets. Securities underwriters are highly susceptible to claims of "fraud by hindsight"[1/]—assertions that disappointing performance by companies whose securities they underwrite demonstrates that prospectuses and other disclosure documents "must have been" fraudulent. *Amici* fear that if the decision below is allowed to stand, underwriters and other participants in the securities markets will face potentially enormous litigation costs as a result of simple business reverses rather than of any wrongdoing. This is particularly so in cases where, as here, the allegations of fraud essentially amount to a claim that things did not turn out as everyone would have wished. Reversal of the Third Circuit's decision in this case is essential to maintaining a proper balance among the rights of all participants in the marketplace.

Amici support the grant of the petition for certiorari for the reasons stated in the petition. They submit this brief in support to emphasize the importance of the issues to American business and to describe the impact of the Third Circuit's decision on the capital markets.

[1/] *Denny* v. *Barber*, 576 F.2d 465, 470 (2d Cir. 1978).

SUMMARY OF ARGUMENT

The Third Circuit's decision in *Shapiro* v. *UJB Financial Corp.*, 964 F.2d 272 (3d Cir. 1992), conflicts with decisions of other circuits on a question of exceptional importance: the standard for pleading fraud under Fed. R. Civ. P. 9(b).[2/] Resolution of this conflict is necessary now because of the uncertainty it creates in the lower courts and because of the violence the *Shapiro* decision does to the fundamental principles underlying Rule 9(b). Moreover, permitting allegations of securities fraud to proceed to discovery without requiring any factual basis for the claims of fraud, as the Third Circuit has done here, is at odds with the policy underlying Rule 11.[3/]

Shapiro is but one of dozens of cases brought in the wake of recent increases in bank loan loss reserves occasioned by the national recession. It alleges that the bank deliberately overstated its financial condition by providing inadequate reserves for loan losses. The complaint, like others of its type, points to an increase in loan loss

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[2/] Rule 9(b) provides:

> **Fraud, Mistake, Condition of the Mind.** In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally.

[3/] Rule 11 provides in pertinent part:

> **Signing of Pleadings, Motions, and Other Papers; Sanctions.** . . . The signature of an attorney or party constitutes a certificate by the signer that the signer has read the pleading, motion, or other paper; that to the best of the signer's knowledge, information, and belief formed after reasonable inquiry it is well grounded in fact and is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law, and that it is not interposed for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation.

reserves from one reporting period to the next and alleges, with little or no factual elaboration, that the reserves established in the earlier periods were fraudulently understated.

Complaints of this type are not limited to the banking industry. Substantial numbers of analogous complaints have been filed against both issuers and underwriters in the wake of disappointing performance by companies that have made public offerings of securities. The Seventh Circuit aptly described this genre of litigation:

> The story in this complaint is familiar in securities litigation. At one time the firm bathes itself in a favorable light. Later the firm discloses that things are less rosy. The plaintiff contends that the difference must be attributable to fraud. "Must be" is the critical phrase, for the complaint offers no information other than the differences between the two statements of the firm's condition. Because only a fraction of financial deteriorations reflects fraud, plaintiffs may not proffer the different financial statements and rest. Investors must point to some facts suggesting that the difference is attributable to fraud.

DiLeo v. *Ernst & Young*, 901 F.2d 624, 627 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990).

The Third Circuit's opinion in *Shapiro* is of fundamental importance in light of the increase in "fraud by hindsight" securities litigation. The Courts of Appeals for the First, Second and Seventh Circuits have blocked these claims by holding that such complaints are insufficient under Rule 9(b) unless they specify "the who, what, when, where, and how"[4] of the alleged false representations. The *Shapiro* decision, however, would allow plaintiffs alleging fraud to sue first and ask questions later. Moreover, *Shapiro* is likely to lead to extensive forum-shopping as securities plaintiffs seek the forum with the most permissive rule on this point.

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[4] *DiLeo*, 901 F.2d 624, 627; *Romani* v. *Shearson Lehman Hutton*, 929 F.2d 875, 878 (1st Cir. 1991); *Denny*, 576 F.2d at 470.

The Supreme Court's authoritative voice is necessary here to provide guidance to and a uniform rule for the lower courts. In light of the considerable number of suits pending in the lower courts which turn on the construction of Rule 9(b) and the recurring nature of this issue, there is an immediate need to dispel the uncertainty created by the Third Circuit's departure from settled principles.

Review is necessary also because the standard applicable to pleadings asserting fraud is of fundamental importance, not only to the banking industry directly involved in *Shapiro*, but to the functioning of the capital markets generally. In any market some percentage of companies will disappoint or even founder, most often as a result of mismanagement or economic decline rather than fraud. If the standard for pleading fraud enunciated by the Third Circuit in *Shapiro* were allowed to stand, the tide of baseless lawsuits brought by disappointed investors in an effort to shift their losses to deeper pockets would threaten to break the dikes. Ordinary business reverses would expose issuers and underwriters to burdensome proceedings absent any evidence of wrongdoing. Due to the magnitude of the potential costs and risks associated with litigating securities fraud cases, especially class actions, many such actions are settled before trial, often with little regard to the merits of the case. The *Shapiro* standard therefore threatens to create a type of "no-fault" insurance against market losses, the costs of which will adversely affect the growth and development of emerging companies.[5] The writ should issue.

ARGUMENT

I.

REVIEW IS NEEDED TO RESOLVE THE CONFLICT AMONG THE CIRCUITS

Under *Shapiro*, a plaintiff lacking facts sufficient to state a Rule 10b-5 claim for fraudulent understatement of loan loss reserves nevertheless may avoid dismissal on Rule 9(b) grounds merely by pleading that the requisite facts lie within the exclusive control of the defendant and

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[5] *See DiLeo*, 901 F.2d at 627.

that unsuccessful efforts have been made to obtain them. *Shapiro*, 964 F.2d at 285. Significantly, the *Shapiro* analysis would apply not only to claims alleging misrepresentations with regard to loan loss reserves, but to all fraud claims where facts supporting allegations of fraud may be claimed to lie within the sole control of the defendants and where plaintiff can delineate his unsuccessful attempts to uncover such facts.[6/] Thus, *Shapiro* holds that a securities plaintiff may unleash the costs and burdens of modern class action litigation without any basis for supposing that fraud occurred save the fallacious assumption that the fact of a business setback demonstrates that its future occurrence was known earlier and deliberately concealed.

Shapiro is at odds with the fundamental purposes of Rule 9(b): (i) to require specificity in allegations of fraud so that defendants have notice of the particular misconduct which is alleged to constitute the fraud and can prepare their defense, (ii) to inhibit the filing of a complaint as a pretext for the discovery of unknown wrongs, and (iii) to protect potential defendants—especially professionals whose reputations in their fields of expertise are most sensitive to baseless aspersions—from the harm that comes from being charged with the commission of fraudulent acts.[7/] Rule 9(b) is designed "to prohibit a plaintiff from unilaterally imposing upon the court, the parties and society enormous social and economic costs absent some factual basis." *Semegen*, 780 F.2d

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[6/] *E.g.*, Edward Brodsky, *Suits Resulting From the Banking Crisis*, N.Y.L.J., July 30, 1992.

[7/] *See, e.g.*, *Cosmas* v. *Hassett*, 886 F.2d 8, 11 (2d Cir. 1989); *New England Data Servs., Inc.* v. *Becher*, 829 F.2d 286, 289 (1st Cir. 1987); *DiVittorio* v. *Equidyne Extractive Indus. Inc.*, 822 F.2d 1242, 1247 (2d Cir. 1987); *Semegen* v. *Weidner*, 780 F.2d 727, 731 (9th Cir. 1985); *Seville Indus. Machinery Corp.* v. *Southmost Machinery Corp.*, 742 F.2d 786, 791 (3d Cir. 1984), *cert. denied*, 469 U.S. 1211 (1985).

at 731.[8] As the court noted in *Beck* v. *Cantor, Fitzgerald & Co., Inc.*, 621 F. Supp. 1547, 1552-53 (N.D. Ill. 1985), if plaintiff

> does not presently possess the relevant, indispensable facts to state a fraud claim with particularity, the precepts upon which Rules 9(b) and 11 are founded mandate that he has no business charging a party with fraud on the slim hope that he may use the various and expensive tools of discovery available under the Federal Rules to put meat on the bare bones of his fraud claim. Fraud is too serious a charge, and litigation is too expensive, to allow such tactics . . . .

Under the Rule 9(b) standard articulated in this case, a plaintiff may proceed with discovery on the basis of purely speculative allegations of fraud in the hope of discovering facts to justify the fraud charges leveled against defendants. The Third Circuit's Rule 9(b) standard as enunciated in *Shapiro* is tantamount to the issuance of a license for a "'fishing expedition' in uncharted waters." *Wayne Inv., Inc.* v. *Gulf Oil Corp.*, 739 F.2d 11, 14 (1st Cir. 1984). Indeed, it conflicts with the policy of Rule 11, which requires that the plaintiff and his or her counsel have a reasonable basis for asserting that the allegations are "well-grounded in fact . . . ." before filing suit.[9]

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[8] *Accord Segal* v. *Gordon*, 467 F.2d 602, 607-08 (2d Cir. 1972)("[a] complaint alleging fraud should be filed only after a wrong is reasonably believed to have occurred; it should serve to seek redress for a wrong, not to find one"); *Denny* v. *Barber*, 73 F.R.D. 6, 10, *aff'd*, 576 F.2d 465 (2d Cir. 1978)("[c]omplaints should not be conceived merely as tokens, guaranteeing access to a world of discovery. . . . Neither plaintiff nor his counsel are entitled to roam through a defendant's files at the mere drop of a 'complaint'"); *McFarland* v. *Memorex Corp.*, 493 F. Supp. 631, 639 (N.D. Cal. 1980) ("[d]iscovery allows parties to develop the facts underlying their claims and defenses; it is not a vehicle for uncovering the claims themselves").

[9] *See Cooter & Gell* v. *Hartmarx Corp.*, 110 S. Ct. 2447, 2454 (1990); *see also* Fed. R. Civ. P. 11 Advisory Committee's Note, 1983 amendment.

Allegations of what Judge Friendly aptly termed "fraud by hindsight"[10] are easily made without significant factual basis. In consequence, the Courts of Appeals for the First, Second and Seventh Circuits have required strict compliance with Rule 9(b).[11] Even where facts pertaining to the alleged fraud are "peculiarly within a defendant's knowledge," most courts have required plaintiffs pleading fraud upon information and belief to allege specific facts upon which their belief is founded.[12] Even the Third Circuit, until the decision below, required that plaintiffs claiming that the facts were within the defendants' control set forth in the complaint "a statement of the facts upon which the allegations are based." *In re Craftmatic Sec. Litig.* v. *Kraftsow*, 890 F.2d 628, 645 (3d Cir. 1989); *see also Christidis* v. *First Pennsylvania Mortgage Trust*, 717 F.2d 96, 99–100 (3d Cir. 1983).

Although the court in *Shapiro* acknowledged *Craftmatic*'s requirement that allegations of fraud must be accompanied by factual support, it nevertheless undercut this requirement. It indicated that a plaintiff may avoid dismissal by alleging only that facts necessary to support an allegation of fraud are in the exclusive possession of the defendants and delineating the nature and scope of plaintiff's efforts to uncover those facts. *Shapiro*, 964 F. 2d at 285. This view would allow a plaintiff to prosecute a securities fraud claim, despite the absence of any facts demonstrating "how" the alleged misconduct departed from proper conduct or "how" the alleged misstatement was inaccurate, merely by stating in the complaint that the plaintiff was unable to discover facts supporting the claim prior to filing the action.

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[10] *Denny*, 576 F.2d at 470.

[11] *See Romani*, 929 F.2d at 878; *DiLeo*, 901 F.2d at 627; *Denny*, 576 F.2d at 470.

[12] *See Romani*, 929 F.2d at 878; *Craighead* v. *E.F. Hutton & Co.*, 899 F.2d 485, 489-90 (6th Cir. 1990); *Moore* v. *Kayport Package Express, Inc.*, 885 F.2d 531, 540 (9th Cir. 1989); *DiVittorio*, 822 F.2d at 1248; *Wayne Inv.*, 739 F.2d at 13-14; *Schlick* v. *Penn-Dixie Cement Corp.*, 507 F.2d 374, 379 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975); 5 Charles A. Wright & Arthur R. Miller, *Federal Practice and Procedure: Civil 2d* § 1298 at 650-660 (1990); 2A James W. Moore & Jo D. Lucas, *Moore's Federal Practice* ¶ 9.03[1] at 9–28 (1991).

The view adopted below is inconsistent not only with the views of other circuits, but with a recent opinion of another Third Circuit panel. On the same day that *Shapiro* was decided, another panel affirmed a judgment which reached an opposite and irreconcilable conclusion on the appropriate standard for pleading fraud under Rule 9(b). *Decker* v. *Landmark Sav. Ass'n*, No. 91-3776 (3d Cir. May 20, 1992). On a very similar set of facts, the *Landmark* panel reaffirmed the requirement that plaintiffs plead facts identifying "how" alleged misstatements were false and "why" defendants would have been on notice of their falsity. *Landmark* is consistent with previously-stated Third Circuit standards[13/] and with the pleading standards adopted by other circuits.

Shapiro thus conflicts with decisions in the First,[14/] Second[15/] and Seventh[16/] Circuits,[17/] as well as the decision of another Third Circuit panel. Certiorari therefore should be granted.[18/]

[13/] *See Christidis*, 717 F.2d at 99–100; *In re Craftmatic*, 890 F.2d at 645–46.

[14/] *Romani* v. *Shearson Lehman Hutton*, 929 F.2d 875, 878 (1st Cir. 1991).

[15/] *Denny* v. *Barber*, 576 F.2d 465, 469–70 (2d Cir. 1978).

[16/] *DiLeo* v. *Ernst & Young*, 901 F.2d 624, 627–28 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990).

[17/] Insofar as it does not require a plaintiff to support allegations of fraud with a statement of facts upon which such allegations are based, or to plead fraud with any degree of particularity, the Third Circuit's decision in *Shapiro* diverges from the decisions of other circuits which have considered the issue. *See, e.g.*, *Hoover* v. *Langston Equipment Assocs. Inc.*, 958 F.2d 742, 745 (6th Cir. 1992); *Farlow* v. *Peat Marwick, Mitchell & Co.*, 956 F.2d 982, 986–87 (10th Cir. 1992); *Whalen* v. *Carter*, 954 F.2d 1087, 1097–98 (5th Cir. 1992); *Guidry* v. *Bank of LaPlace*, 954 F.2d 278, 288 (5th Cir. 1992); *Craighead* v. *E. F. Hutton & Co.*, 899 F.2d 485, 489–90 (6th Cir. 1990); *Moore* v. *Kayport Package Express, Inc.*, 885 F.2d 531, 540 (9th Cir. 1989).

[18/] Certiorari should be granted also pursuant to Sup. Ct. R. 10.1.(c). The Third Circuit's statement in *Shapiro*—that "[b]y addressing the quality of a particular management practice, a defendant declares the subject of its

(continued...)

II.

REVIEW SHOULD BE GRANTED BECAUSE OF THE IMMEDIATE IMPORTANCE OF THE STANDARD FOR PLEADING FRAUD TO THE FUNCTIONING OF THE CAPITAL MARKETS

It is essential that the Court prevent the development of a rule exposing banks, other issuers, and securities underwriters to costly litigation every time their business or, in the case of underwriters, the business of an issuer whose securities they have underwritten, declines. The federal "[s]ecurities laws do not guarantee sound business practices and do not protect investors against reverses." *DiLeo*, 901 F.2d at 627. Absent some requirement that plaintiffs do more than allege in conclusory fashion that defendants' conduct or statements constitute fraud, the securities laws become nothing more than an *in terrorem* weapon to coerce settlements, a form of insurance policy tending to place the shareholder in a "no lose" situation. *See Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 741 (1975).

This tendency is greatly magnified by the potential for abuse of the liberal discovery provisions of the Federal Rules of Civil Procedure. "[E]ven a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment." *Blue Chip*, 421 U.S. at 740.

> [T]he mere existence of an unresolved lawsuit has settlement value to the plaintiff not only because of the possibility that he may prevail on the merits, an entirely legitimate component of settlement value, but because of the threat of extensive discovery and disruption of normal business activities which may accompany a law-

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[12/](...continued)
representation to be material to the reasonable shareholder, and thus is bound to speak truthfully" (964 F.2d at 282)—takes an approach expressly rejected by this Court in *Basic, Inc.* v. *Levinson*, 485 U.S. 224 (1988).

> suit which is groundless in any event, but cannot be proved so before trial.

Id. at 742–43.

Extensive depositions of the defendant officers and associates, and far reaching discovery of business documents, are common and costly occurrences in securities litigation today. Rule 9(b) thus operates to diminish the possibility that a plaintiff with a groundless claim will be permitted to conduct extensive, expensive and time consuming discovery "with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the process will reveal relevant evidence. . . ." *Blue Chip*, 421 U.S. at 741. It functions to prohibit a plaintiff from unilaterally imposing upon the defendant, the court and society enormous social and economic costs absent a sufficient factual basis to which counsel is willing to attest under Rule 11.

The cost of too permissive a standard for stating a securities fraud claim goes well beyond the expense of discovery and a motion for summary judgment or trial. Defendants in such actions, as in others, constantly must decide whether to litigate to judgment or settle. The magnitude of potential class action liability under the securities laws, particularly since the acceptance of the fraud on the market theory,[19] is enormous, often so great as to threaten the continued health or existence of the company sued. Accordingly, the vast majority of these cases are settled before trial, frequently in spite of the defendants' confidence in their ability to prevail at trial, because even a small risk of an adverse result is too great to bear. Indeed, recent empirical research confirms that the settlement process in such cases often is divorced from expected trial outcomes because the sheer magnitude of the exposure leaves the defendants without practical access to an adjudicated resolution.[20]

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[19] *Basic*, 485 U.S. 224 (1988).

[20] Janet C. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497, 500 (1991).

In these circumstances, the importance of the standard applied to determine the sufficiency of a securities fraud complaint cannot be gainsaid. Since the denial of a motion to dismiss the complaint effectively subjects the defendants to the substantial cost of far reaching discovery, and in many cases can deprive them of the opportunity to defend on the merits except by running extraordinary risks, the standard has a profound impact on the outcomes of such cases. These are outcomes, moreover, that go far beyond the private interests of the immediate parties. Since securities fraud actions reflect private enforcement of important public regulatory policies, there is a substantial public interest in ensuring that the outcomes reached fairly reflect the merits.[21/] And there is no public interest served by the *Shapiro* rule, which will subject securities market participants to potentially debilitating costs as the result of normal business reverses where there are no facts suggestive of fraud. Increased risks associated with public offerings in turn will raise the level of compensation required by underwriters assuming such risks and thus will operate to limit access to the capital markets. One well might expect fewer companies to consider raising capital by going public.[22/]

To say that underwriters can avoid these costs through increased disclosure is to ignore the practical realities of the situation. Even if it were possible to eliminate all risk of "fraud by hindsight" securities litigation through enhanced disclosure, such disclosure would not be without cost. Cost aside, moreover, even the most extensive disclosure would not eliminate the risks associated with such litigation because so many of the allegations leveled relate to the correctness of inherently subjective business judgments. In this case, for example, the complaint attacks loan loss reserves, which in the best of circumstances are merely estimates of future losses that are not susceptible of objective verification.[23/]

[21/] Alexander, *supra*, at 501.

[22/] *See* Alexander, *supra*, at 571.

[23/] *See Christidis*, 717 F.2d at 100 ("reserves were estimates or predictions of the likely collection or liquidation experience ... in the future"); *TCF Banking & Sav. F.A.* v. *Arthur Young & Co.*, 706 F. Supp. 1408, 1412 (D. Minn. 1988) (establishment of loan loss reserve "involves economic forecasting, not the reporting of known facts").

As the Court of Appeals for the Seventh Circuit stated in *DiLeo* v. *Ernst & Young*, "[s]ecurities laws designed to protect investors' interests should not be read to increase the costs of ordinary business and so disserve their own ends." *DiLeo*, 901 F.2d at 627. If the standard for pleading fraud set forth in *Shapiro* were deemed sufficient, "the advent of a recession could be expected to trigger a multitude of complaints in which plaintiffs seek to impose liability for their financial disappointments based on entirely fabricated scenarios of fraud." *Romani*, 929 F.2d at 880. Under *Shapiro*, no matter how improbable the allegations of a plaintiff, a case alleging securities fraud would be virtually impossible to dispose of prior to extensive discovery other than through the settlement process. The Rule 9(b) standard currently employed in the First, Second and Seventh Circuits, on the other hand, would permit the dismissal, prior to trial, of those plaintiffs who seek to sue first and ask questions later. We therefore urge the Court to take review and reverse the decision of the Third Circuit.

CONCLUSION

For the foregoing reasons, *amici* respectfully request that the petition for certiorari be granted.

Dated: August 19, 1992

Respectfully submitted,

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No. 92-267

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In The

Supreme Court of the United States

October Term, 1992

UJB FINANCIAL CORP., et al.,

Petitioners,

v.

IRWIN SHAPIRO, ROBERT BASSMAN, JEROME KATZ, NORMAN SALTSITZ, JEAN LEE, and CHAPPAQUA FAMILY TRUST,

Respondents.

Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Third Circuit

RESPONDENTS' RESPONSE TO MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

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Respondents Irwin Shapiro, Robert Bassman, Jerome Katz, Norman Saltsitz, and Jean Lee (collectively, "Respondents") respond to the motion of Dean Witter Reynolds Inc., Morgan Stanley & Co. Inc., PaineWebber Inc., Wertheim Schroder & Co. Inc., and the Securities Industry Association (collectively, "Movants") to file a brief *amicus curiae* in support of the Petitioners. The motion disregards the rules of this Court, and should be denied.

This Court's rules governing the filing of briefs *amicus curiae* at the petition stage explicitly warn potential *amici* against filing motions for leave to file a brief where consent has been withheld, and against filing proposed briefs with redundant arguments. Rule 37.1 of this Court's rules states:

> An *amicus curiae* brief which brings relevant matter to the attention of the Court that has *not already been brought to its attention* by the parties is of considerable help to the Court. An *amicus* brief which does not serve this purpose simply burdens the staff and facilities of the Court and *its filing is not favored.*

Sup. Ct. Rules 37.1 (emphasis added). Rule 37.2 goes on to state that "a motion for leave to file a brief *amicus curiae* when consent has been refused is not favored." Even the most generous reading of Rule 37, in light of the arguments that Movants seek to make, requires denial of their motion.

Movants previously sought Respondents' consent for the filing of a brief *amicus curiae*. Respondents withheld their consent based upon their belief that any brief *amicus curiae* would not aid in this Court's consideration of the petition for a writ of *certiorari*. Movants' proposed brief has confirmed Respondents' belief. The proposed brief simply reiterates arguments that Petitioners already have

made, and does not bring to the Court any matter, relevant or otherwise, that has not otherwise been brought to its attention. The proposed brief serves no purpose beyond adding to the burden of the Court's staff and facilities. Given the plain language of Rule 37, the motion and proposed brief should never have been filed.

Because Movants' proposed brief *amicus curiae* does not bring anything new to this Court's attention, as is required by Rule 37, and because this Court's rules specifically discourage motions for leave to file a brief *amicus curiae* where consent has been withheld, Movants' motion should be denied.

DATED: August 26, 1992

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IN THE

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OCTOBER TERM, 1992

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Petitioners,

v.

IRWIN SHAPIRO, ROBERT BASSMAN, JEROME KATZ, NORMAN SALSITZ, JEAN LEE and CHAPPAQUA FAMILY TRUST,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

REPLY IN SUPPORT OF MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* OF DEAN WITTER REYNOLDS, INC., MORGAN STANLEY & CO. INCORPORATED, PAINEWEBBER INCORPORATED, WERTHEIM SCHRODER & CO. INCORPORATED AND THE SECURITIES INDUSTRY ASSOCIATION, IN SUPPORT OF PETITIONERS

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Amici Dean Witter Reynolds, Inc., Morgan Stanley & Co. Incorporated, PaineWebber Incorporated, Wertheim Schroder & Co. Incorporated and the Securities Industry Association submit this reply in support of their motion to file a brief *amicus curiae*.

Respondents make two assertions in opposition to the motion. First, they maintain that "[t]he motion disregards the rules of this Court . . ." Second, they maintain that the brief is redundant. They are mistaken on both counts.

1. Rule 37 does not, as respondents would have it, prohibit motions for leave to file briefs *amicus curiae* where, as here, one of the parties withholds consent. If it did, parties fearing the impact on their prospects of the views of *amici*, like respondents here, would hold an absolute veto over the ability of the Court to benefit from the expression of those views. Persons seeking to present their views as *amici* quite plainly have the right to file such motions. Indeed, a leading commentator has indicated that *amici* "should not be deterred by the warning" that motions for leave to file briefs *amicus curiae* are disfavored absent consent, noting that the Court in fact is quite receptive to such motions. R. STERN, E. GRESSMAN & S. SHAPIRO, SUPREME COURT PRACTICE 395 (6th ed. 1986).

The interest of *amici* in this case is plain, and their motion has been filed well in advance of the Court's consideration of the case. In consequence, the suggestion that *amici* disregarded the rules of the Court is meritless.

2. Respondents' contention that the proposed brief of *amici* merely repeats what has been said by petitioners is equally misguided. *Amici* have addressed the issues raised by this case from the standpoint of underwriters of securities and participants in securities class action litigation. They have sought to

demonstrate that reversal of the decision below is of special importance to the proper functioning of the capital markets. These points were not developed by the petitioners.

Dated: September 2, 1992

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BRIEF OF RESPONDENT IRWIN SHAPIRO IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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QUESTIONS PRESENTED

1. Should Petitioners' writ of certiorari be granted in a securities fraud suit to consider the highly fact-specific issue of whether a complaint complies with Rule 9(b), Fed.R.Civ.P., where (a) in an interlocutory ruling, the Court of Appeals agreed with Petitioners and the District Court that Respondents' complaint failed to allege fraud with the particularity required by Rule 9(b) and remanded the case to the District Court directing Respondents to amend their complaint, and (b) the Court of Appeals decision followed the legal standards utilized by courts in every Circuit in the United States.

2. Was the Court of Appeals correct in holding, in conformance with a long line of this Court's decisions, that statements of material facts made by corporate officers and directors must be truthful?

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No. 92-267

IN THE

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Respondents.

BRIEF OF RESPONDENT IRWIN SHAPIRO IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

STATEMENT OF THE CASE

This case, a securities class action suit, alleges violations of the Securities Act of 1933 and the Securities Exchange Act of 1934 ("Exchange Act") by defendants. The District Court dismissed the complaint and the Court of Appeals agreed that the complaint did not satisfy the requirements of Rule 9(b) of the Federal Rules of Civil Procedure and remanded the case, *inter alia*, so that the plaintiffs could amend and attempt to satisfy Rule 9(b). Defendants below, successful in their argument that the complaint failed to comply with Rule

9(b), have filed this Petition For A Writ Of Certiorari challenging the Rule 9(b) ruling of the Court of Appeals.

Irwin Shapiro and the other plantiffs below, Respondents herein, filed a Consolidated Amended Class Action and Derivative Complaint ("Complaint") on their own behalf and on behalf of a plaintiff class consisting of all persons who purchased the publicly traded securities of UJB Financial Corp. ("UJB" or the "Company") during the period beginning approximately February 1, 1988 through and including July 18, 1990 (the "Class Period"). The defendants in this action are UJB, a multi-billion dollar interstate bank holding company, as well as certain of UJB's senior-most officers and directors, including members of the "Audit Committee" of UJB's Board of Directors. Plaintiffs charge that defendants issued a series of materially false and misleading statements to the investing public during the Class Period in violation of Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder by the Securities and Exchange Commission.

The gravamen of the Complaint is that throughout the Class Period, defendants issued public releases and statements that misrepresented UJB's true financial condition by, *inter alia*, overstating UJB's reported income and assets by consciously understating its reserves for loan losses. The Complaint further charges that defendants falsely represented UJB to the public as a growing, well-managed, and profitable institution, with highly conservative lending practices, a diverse loan portfolio, and adequate reserves to cover potential loan problems. Further, defendants falsely represented that UJB's internal loan review procedures and policies were stringent and provided continuous monitoring of the quality of the loan portfolio and potential loan problems. (A-3-A-10). This false portrait of UJB deceived the investing public (including plaintiffs and members of the Class) into making purchases of UJB securities during the Class Period at artificially inflated prices, thereby sustaining substantial losses. The Complaint

describes in exacting detail when and where defendants lied about the condition of UJB, in which public pronouncements these false statements appeared, who made or was responsible for those statements, and how those statements were false and misleading.

UJB stunned the investment community when, for the first time, in press releases dated April 18 and July 18, 1990, it acknowledged some problems with its loan portfolio. In these press releases, the Company announced that it would be increasing its loan loss reserves by $20 million and $40 million, respectively, for the first and second quarters of 1990. On October 17, 1990, UJB shocked the investment community further by reporting a loss of nearly $20 million for the quarter ending September 30, 1990, compared with reported net income of over $31 million for the quarter ending September 30, 1989. UJB further announced in its October 17 press release that it had added $124 million to its loan loss reserves, $113 million more than it had set aside in the third quarter of 1989. UJB disclosed in this press release that the enormous addition to loan loss reserves was necessitated by a $171 million increase during the quarter in non-performing loans (i.e. those loans seriously delinquent or being repaid under eased terms). As a result of the disclosures of the truth, the common stock of UJB, which traded in excess of $25 per share during the Class Period, fell to an all-time low of $6.50 per share.

The district court found that many of plaintiffs' allegations did not satisfy the requirements of Rule 9(b), Fed.R.Civ.P., which requires that allegations of fraud be pleaded with particularity. (A-49-A-50). The district court dismissed the remaining allegations of the Complaint pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure, ruling that such allegations constituted "nothing more than assertions of mismanagement" rather than misstatements and omissions of material facts, and therefore not actionable under the federal securities laws. (A-41).

The Court of Appeals agreed with the district court that the complaint did not satisfy the specificity requirements of Rule 9(b), and granted plaintiffs leave to amend their complaint to attempt to comply with Rule 9(b), leaving "it to the district court to evaluate in the first instance the particularity of these allegations" (A-24-A-25).

With respect to those charging allegations of the complaint dismissed by the district court pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure, the Court of Appeals held that many of these allegations appeared to involve allegations of untrue statements of material fact under this Court's decisions in *TSC Industries, Inc. v. Northway, Inc.*, 424 U.S. 438 (1976), and *Virginia Bankshares, Inc. v. Sandberg*, ___U.S. ___, 111 S.Ct. 2749 (1991), which require that statements of material facts by corporate officers and directors must be truthful. (A-15-A-22). However, the Court of Appeals ruled that "plaintiffs' style of pleading has made it difficult to parse the complaint, primarily because many of the actionable allegations were intermingled with the inactionable." (A-21). The Court of Appeals therefore remanded the case to the district court, reasoning (A-22):

> . . . in light of the confusion that pervades plaintiffs' allegations, we conclude that the entire complaint must be reorganized. Therefore, on remand plaintiffs should rearrange the existing allegations into discrete units that are, standing alone, each capable of evaluation under the legal principles we have set forth.

After the Court of Appeals' decision was issued, Petitioners filed in the Court of Appeals a request for rehearing or rehearing *en banc*. The purported basis for the request was that the Court of Appeals decision conflicted with the Third Circuit's not-for-publication, one paragraph Judgment Order in *Decker v. Landmark Savings Ass'n*, No. 91-3776 (3d Cir. May 20, 1992), and

its decision in *Christidis v. First Pennsylvania Mortgage Trust*, 717 F.2d 96 (3d Cir. 1983). Recognizing that there was no conflict, the original panel denied Petitioners' request for rehearing and the full Court of Appeals for the Third Circuit, denied Petitioners' request for rehearing *en banc* by Order dated July 2, 1992. (A-51).

SUMMARY OF REASONS WHY THE PETITION SHOULD BE DENIED

There is no need to grant certiorari to decide any of the issues raised by Petitioners. As demonstrated below, the "Questions Presented For Review" by Petitioners simply do not relate to the decision of the Court of Appeals. Contrary to the issues set forth in the Petition, the Court of Appeals did not "eviscerate" Rule 9(b)'s pleading requirement; nor did the Court of Appeals "announce[] a new, 'relaxed' application of Rule 9(b), Fed.R.Civ.P." which "contradicts" either the standards applicable in any other Circuit or within the Third Circuit. In fact, the Court of Appeals agreed with the district court and Petitioners that the Complaint did not satisfy the requirements of Rule 9(b). Consistent with standards governing amendments of pleadings found to be deficient, the Court of Appeals remanded the case to the district court and granted leave to amend the Complaint to attempt to satisfy Rule 9(b). The Court of Appeals specifically left "it to the district court to evaluate in the first instance the particularity of these allegations." (A-25). *Thus, there is at present no viable complaint for this Court to review.* This case therefore is simply not ripe for consideration by this Court. *Brotherhood of Locomotive Firemen v. Bangor & Aroostock R. Co.*, 398 U.S. 327, 328 (1968). It would be premature for this Court to consider this case, as nothing more than an advisory opinion concerning the scope of Rule 9(b) can be offered by this Court on the present record.

Nor is there a conflict between the decision of the Court of Appeals here and the decisions of other Courts

of Appeals or other decisions of the Third Circuit concerning the requirements of Rule 9(b). The decision below follows the same standards that have been applied by courts throughout the United States for many years. The fact that there are numerous decisions both sustaining and dismissing complaints under Rule 9(b) underscores the fact that complaints differ, and the differing results in these cases demonstrate nothing more than different conclusions concerning different complaints reached by applying compatible standards. Indeed, a ruling under 9(b) – that a complaint does or does not plead the circumstances of an alleged fraud with sufficient particularity – is unquestionably one of the most fact-intensive, fact-specific and case-by-case rulings a district court can be called upon to make on any subject. The very essence of the court's inquiry is, indeed, factual. Nor could it be otherwise, since the court is called upon to gauge whether or not sufficient factual particularity is set out by the averments of the complaint.

Defendants also contend that review of this case is necessary because the Court of Appeals ruled that a fact becomes "material" within the meaning of the securities laws simply by virtue of its being discussed by management in its public reports. This is simply not true. Indeed, in addressing the issue of "materiality," the Court of Appeals "provided an extensive review of the Supreme Court's jurisprudence on materiality" (A-15-A-16). The Court of Appeals also reaffirmed that a fact is "material" within the meaning of the securities laws *only if,* after a "delicate assessment[] of the inferences a reasonable shareholder would draw from a given set of facts," "there is a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder" and "whether there is a substantial likelihood that the disclosure would have been viewed by the reasonable investor as having 'significantly altered the "total mix" of information available to

that investor.' " (A-15-A-16) (quoting *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)). The Court of Appeals also reaffirmed that "[o]nly if the alleged misrepresentations and omissions are so obviously unimportant to an investor that reasonable minds cannot differ on the question of materiality is it appropriate for the district court to rule that the allegations are inactionable as a matter of law." (A-16) (citing *TSC Industries, Inc.*, 426 U.S. at 449)). The Court of Appeals followed all Supreme Court precedent in reaching this result.

I. PETITIONERS ARE SEEKING A HYPOTHETICAL, INTERLOCUTORY ADVISORY OPINION, AS THE COURT OF APPEALS BELOW AGREED WITH THE DISTRICT COURT THAT THE COMPLAINT FAILS TO PASS MUSTER AND GRANTED PLAINTIFFS LEAVE TO AMEND THEIR COMPLAINT

Petitioners' request that this Court grant certiorari and consider this case erroneously presupposes that the Court of Appeals below has upheld the allegations of the complaint against defendants under Rule 9(b). But this is exactly the opposite of what occurred below. It cannot be overstated that the Court of Appeals *agreed* with the district court and Petitioners that plaintiffs' complaint did *not* satisfy the requirements of Rule 9(b). Thus Petitioners have failed the first test for consideration by this Court. They are not even aggrieved by the Order below. They contended that the Complaint did not satisfy Rule 9(b) and both the district court and Court of Appeals agreed. The Court of Appeals remanded the case to the district court and granted plaintiffs leave to amend their complaint to comply with the particularity requirements of Rule 9(b). (A-24-A-25).[1] The Court of

1. In so ruling, the Court of Appeals followed the proper procedure universally followed by courts under analogous circumstances. *See* 2A Moore & Lucas, *Moore's Federal Practice* ¶9.03 at 9-34 (2d ed. 1984). *See also Yoder v. Orthomolecular National*

Appeals left "it to the district court to evaluate in the first instance the particularity of these allegations." (A-25).

Thus, the question of whether Respondent has – or can – plead an adequate complaint is entirely speculative, hypothetical and premature, given the Court of Appeals' direction to amend the Complaint to excise inactionable allegations, to clarify claims, and to add more particularity in allegations. Under these circumstances, it would be a wasteful exercise for this Court to determine whether the first version of the Complaint – which has been directed to be amended by the Court of Appeals – is sufficiently specific to satisfy Rule 9(b). This Court has consistently refused to consider hypothetical questions and to issue advisory opinions at an interlocutory stage of a case, which would be the result here if certiorari were to be granted to consider the allegations of a complaint that is no longer operative and a case which has been remanded. *See Brotherhood of Locomotive Firemen v. Bangor & Aroostook R. Co.,* 389 U.S. 327, 328 (1967) (denying certiorari "because the Court of Appeals remanded the case [and thus the case] is not yet ripe for review by the Court."). Whether Respondent's new complaint, which is not yet in existence, ultimately pleads fraud with sufficient particularity is obviously a question that cannot be answered at this time.

NOTES *(Continued)*

Institute Inc., 751 F.2d 555, 562 & n.6 (2d Cir. 1985); *Luce v. Edelstein,* 802 F.2d 49, 56-57 (2d Cir. 1979), *cert. denied,* 446 U.S. 946 (1980) ("because we are hesitant to preclude the prosecution of a possibly meritorious claim because of defects in the pleadings, we believe that the plaintiffs should be afforded an additional, albeit final opportunity to conform the pleadings to Rule 9(b).").

II. A RULE 9(b) DECISION IS EXTREMELY FACT-SPECIFIC AND IS NOT THE TYPE OF ISSUE THIS COURT CONSIDERS

In their attempt to have this Court believe that there is a conflict among the Circuits concerning the standards required to satisfy Rule 9(b), Petitioners present a number of Court of Appeals and district court decisions on the application of Rule 9(b) to individual complaints, in an effort to create the illusion of a "conflict" among the Circuits and "confusion" at the district court level. However, this variation in results does not represent any "conflict" or "confusion." These decisions – some sustaining complaints and others dismissing or affirming the dismissal of complaints – serve only to emphasize the fact that any determination of whether Rule 9(b)'s particularity requirement has been satisfied requires an individualized assessment of the unique allegations contained in the specific complaint under consideration. And individualized fact-specific issues which cannot be generally applicable are simply not the type that this Court hears and decides. Indeed, this Court has consistently denied certiorari when review is sought of a lower court decision which turns solely upon an analysis of the particular facts involved, or upon the analysis of particular documents. *See, e.g., United States v. Johnston,* 268 U.S. 220, 227 (1925) ("[w]e do not grant certiorari to review evidence and discuss specific facts"); *NLRB v. Hendricks Rural Electric Corp.,* 454 U.S. 170, 176 n.8 (1981) (improvident grant of certiorari that presented primarily a question of fact "which does not merit Court review").

The decisions applying Rule 9(b) that Petitioners cite as evidence of "confusion" each turn almost entirely on the specific allegations of the particular complaint at hand, not on any claimed variation in the standards for applying Rule 9(b). This was recognized by the court in *Urbach v. Sayles,* 779 F.Supp. 351 (D.N.J. 1991) when it rejected the notion that the existence of decisions

sustaining and dismissing complaints under Rule 9(b) (including many of the decisions upon which Petitioners focus) represented a "conflict" concerning the appropriate standards to be applied under Rule 9(b). The court reasoned that "[a]lthough the authorities cited by defendant rejected plaintiffs' fraud claims for failure to satisfy Rule 9(b), the showing of particularity there required is no different from the standard enunciated by this Court and satisfied by the plaintiff". 779 F.Supp. at 364.

A decision by this Court concerning what might be appropriate allegations under Rule 9(b) in this complaint against UJB would do little to aid district courts in the future, since those courts will still have to carefully consider the specific factual allegations that are pled in the complaints before them. This Court has consistently denied petitions for writs of certiorari to review Court of Appeals decisions involving Rule 9(b). *See, e.g., DiLeo v. Ernst & Young,* 901 F.2d 624 (7th Cir.), *cert. denied,* 111 S.Ct. 347 (1990); *Luce v. Edelstein,* 802 F.2d 49 (2d Cir. 1979), *cert. denied,* 446 U.S. 946 (1980); *Seville Industrial Machinery Corp. v. Southmost Machinery Corp.,* 742 F.2d 786 (3d Cir. 1984), *cert. denied,* 469 U.S. 1211 (1985); *Ross v. A.H. Robins Co.,* 607 F.2d 545, 557 n.20 (2d Cir. 1979), *cert. denied,* 446 U.S. 846 (1980); *Deane v. Thomson McKinnon Securities, Inc.,* 586 F.Supp. 44, 48 (D.D.C. 1984), *aff'd,* 762 F.2d 137, *cert. denied,* 474 U.S. 903 (1985).

III. THERE IS NO CONFLICT – WHETHER INTER- OR INTRA-CIRCUIT – CONCERNING THE STANDARDS APPLICABLE UNDER RULE 9(b)

A. *There Is No Conflict Among The Circuits Concerning The Proper Application of Rule 9(b)*

Petitioners contend that this Court should grant *certiorari* "to address a conflict among the Circuits" concerning the proper pleading standards required by Rule 9(b). (Pet. at 8). Defendants even go so far as to contend that this supposed "inter-Circuit conflict . . . is

crystal clear." (Pet. at 9). In support of their claim of an inter-Circuit conflict, Petitioners contend that the decision of the Court of Appeals below is in an "irreconcilable" conflict with the decisions of the Second Circuit in *Denny v. Barber*, 576 F.2d 465 (2d Cir. 1978), the First Circuit in *Romani v. Shearson Lehman Hutton*, 929 F.2d 875 (1st Cir. 1991), and the Seventh Circuit in *DiLeo v. Ernst & Young*, 901 F.2d 624 (7th Cir. 1990). Petitioners are wrong.

The fact that some courts have dismissed complaints under Rule 9(b) and others have upheld complaints is not the result of varying standards among the Circuits. Rather, as indicated above, it is simply a reflection of the obvious fact that any determination of whether Rule 9(b)'s particularity requirement has been satisfied requires an individualized assessment of the unique allegations contained in the specific complaint under consideration, and results will necessarily vary given the fact that individual complaints will vary. This point was made most clearly by Judge Friendly in *Denny v. Barber*, one of the three decisions Petitioners erroneously rely upon in support of their claim of "irreconcilable conflict":

> Plaintiff's counsel has called our attention to a number of district court decisions . . . which are alleged to have sustained complaints no more specific than this. Defendants dispute this and counter with an equal number of district court decisions alleged to have dismissed complaints more specific than this one. *We see no profit in attempting to analyze these decisions, which may or may not be consistent and each of which necessarily rests on its particular facts.*

576 F.2d at 470 (emphasis added).

The "conflict" among the Circuits, according to Petitioners, is that the decision of the Court of Appeals below "permits a plaintiff to prosecute a securities fraud

action, despite plaintiff's inability to plead any facts demonstrating how any defendant's behavior departed from proper conduct, or how any defendant's statement was inaccurate (much less fraudulent), solely on the ground that such plaintiff claims to have been unable to uncover any such facts prior to the filing of a complaint." (Pet. at 8). Petitioners' argument misstates the ruling of the Court of Appeals below.

It bears repeating that the Court of Appeals below *agreed* with the district court that the Complaint, as pleaded, did not satisfy the requirements of Rule 9(b), and directed plaintiffs to replead to attempt to satisfy Rule 9(b). Indeed, the Court of Appeals below emphasized that the threshold for satisfying Rule 9(b) is a "stringent" one (A-23), and emphasized that one of the purposes of the Rule is "to ensure that plaintiffs thoroughly investigated all possible sources of information, including but not limited to all publicly available relevant information, before filing a complaint" (A-24), and required a securities fraud plaintiff to delineate his efforts to discover information prior to filing his complaint. This is hardly an endorsement of a "sue first, find claims later" approach (Pet. at 24). It is therefore by no means surprising that commentators have described the decision of the Court of Appeals below as a victory for defendants charged with violations of the securities laws. *See* J.B. Kasner, R.W. Gordon, *Shareholder Suits: Ruling A Victory For Banks,* American Banker, August 5, 1992 ("Significantly, . . . the appeals court reaffirmed that plaintiffs must specifically provide a factual basis for their allegations of fraudulent conduct.").

What Petitioners seize upon in their effort to create the impression of a "conflict" is that the Court of Appeals below simply repeated the fundamental axiom that, when applying Rule 9(b), courts should be mindful of the fact that "application of the Rule prior to discovery 'may permit sophisticated defrauders to successfully conceal the details of their fraud,' " and therefore:

> . . . where the facts are in the exclusive possession of the adversary, courts should permit the pleader to allege the facts on information and belief, provided a statement of the facts upon which the belief is founded is proffered.

(A-24) (quoting, 2 A. James W. Moore & Jo D. Lucas, *Moore's Federal Practice,* ¶9.03[1] at 9-29 to 9-29 (1991)). The Court of Appeals further stated that, as an added safeguard:

> To avoid dismissal in these circumstances, a complaint must delineate at least the nature and scope of plaintiffs' effort to obtain, before filing the complaint, the information needed to plead with particularity. This requirement is intended to ensure that plaintiffs thoroughly investigate all possible sources of information, including but not limited to all publicly available relevant information, before filing a complaint.

(A-24).

There is nothing new, or unique, about the Court of Appeals decision below in this regard, as evidenced by the Court's citation to an extensive, supportive quotation from *Moore's Federal Practice*. Moreover, it is a principle recognized by decisions within every Circuit, including the First, Second and Seventh Circuits with which Petitioners contend that the decision below "conflicts." *See:*

First Circuit – New England Data Servs., Inc. v. Becher, 829 F.2d 286, 288-89 (1st Cir. 1987)(pleading on information and belief permissible if information "is likely in the exclusive control of the defendants.").

Second Circuit – DiVittorio v. Equidyne Extractive Industries, Inc., 822 F.2d 1242, 1247 (2d Cir. 1987)(allegations of fraud may be based on information and belief "as to facts peculiarly within the opposing party's knowledge, in which event the allegations must be accompanied by a statement of the facts upon which

the belief is based") and *Wexner v. First Manhattan Co.*, 902 F.2d 169, 172 (2d Cir. 1990)("[d]espite the rigid requirement that fraud be pleaded with particularity, allegations may be based on information and belief when facts are peculiarly within the opposing party's knowledge.").

Fourth Circuit – Sweeney Co. of Maryland v. Engineers-Constructors, Inc., 109 F.R.D. 358, 360 (E.D. Va. 1986)("[i]f . . . plaintiffs do not have access to information, 'some relaxation of Rule 9(b) is necessary when plaintiffs are not likely to have more specific information until after discovery.' ").

Fifth Circuit – Cadle Co. v. Schultz, 779 F.Supp. 392, 396 (N.D. Tex. 1991) (under Rule 9(b), "a complaint alleging a cause of action for fraud must state with particularity the circumstances constituting the fraud. . . . [I]f the information surrounding the allegations is peculiarly within the knowledge of the defendant, less detail is required in the complaint.").

Sixth Circuit – Michaels Building Co. v. Ameri-Trust Co., N.A., 848 F.2d 674, 680 (6th Cir. 1988) ("[c]ourts have held that the rule may be relaxed where information is only within the opposing party's knowledge. . . . Rule 9(b) does not require omniscience").

Seventh Circuit – Bankers Trust Co. v. Old Republic Ins. Co., 959 F.2d 677, 680 (7th Cir. 1992)(Rule 9(b)'s requirements of pleading the circumstances constituting fraud with particularity can be fulfilled by pleading those circumstances on "information and belief" if "they were facts inaccessible to the plaintiff, in which event he [has] to plead the grounds for his suspicion").

Eighth Circuit – Fusco v. Xerox Corp., 676 F.2d 332, 337 & n.7 (8th Cir. 1982)("[a]ll that is required [under Rule 9(b)] is a short, plain statement of facts sufficient to give the defendant fair notice of the basis of the claim . . . where the proof is largely in the control of the defendant").

Ninth Circuit – Kayport v. Package Express, Inc., 885 F.2d 531, 540 (9th Cir. 1989)("in cases of corporate fraud, plaintiffs will not have personal knowledge of all of the underlying facts. . . . In such cases, the particularity requirement may be satisfied if the allegations are accompanied by a statement of the facts on which the belief is founded."); *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1439 (9th Cir. 1987)(same).

Tenth Circuit – Scheidt v. Klein, 956 F.2d 963, 967 (10th Cir. 1991) ("[a]llegations of fraud may be based on information and belief when the facts in question are peculiarly within the opposing party's knowledge and the complaint sets forth the factual basis for the plaintiff's belief.").

Eleventh Circuit – Durham v. Business Management Associates, 847 F.2d 1505, 1511-12 (11th Cir. 1988) (in a case involving alleged corporate fraud, "[t]he application of the rule, however, must not abrogate the concept of notice pleading. . . . Allegations of date, time or place satisfy the Rule 9(b) requirement that fraud be pleaded with particularity, but alternative means are also available to satisfy the rule."); *First American Bank & Trust by Levitt v. Frogel*, 726 F.Supp. 1292, 1295 (S.D. Fla. 1989)(". . . in case of corporate fraud, the plaintiff cannot expect to have personal knowledge of all of the facts constituting the wrongdoing. Particularity is satisfied by a statement of the facts upon which the belief of fraud is founded. . .").

District of Columbia Circuit – Kowal v. MCI Communications Corp., Civil Action No. 90-2862 (JGP), 1992 U.S. Dist. LEXIS 7437 (D.D.C. May 20, 1992)(allegations of fraud based on information and belief permissible "as to matters peculiarly within the knowledge of the other party . . ." if "the allegations [are] accompanied by a statement of the facts upon which the belief is founded.").

Thus, it is readily apparent that the decision of the Third Circuit is in complete accord with decisions within all of the other Circuits concerning the proper standard

to be applied in assessing the sufficiency of a complaint under Rule 9(b), and the fact that some courts have upheld complaints and some have dismissed them is readily explained by differences in the factual allegations of the various complaints. There is no conflict among the Circuits. [2]

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2. The three cases cited by Petitioners do not support their conflict argument. Rather those cases turned on their own unique facts.

For example, in *Denny,* the Second Circuit affirmed, for lack of specificity, the dismissal of a federal securities complaint brought by the purchasers of 15 shares of stock against a financial institution and its directors. The Court emphasized that "[t]he amended complaint does not state what items in the 1973 Annual Report were knowingly false," 576 F.2d at 469, did not identify any misleading statement in a document filed with the SEC" (576 F.2d at 470 & n.4), and there was "not even an indication of the date at which defendants knew the investments had become so 'risky' that disclosure was required." *Id.* at 470. It is therefore by no means surprising that the Second Circuit, after carefully considering the factual circumstances before it, affirmed the dismissal of the complaint. It did not set up any different legal standard than applied by the courts below. (The District Court below required specificity of "particular statements which are allegedly false, as well as when, where, and by whom those claims were made." (A-49).)

Similarly, in *Romani,* the First Circuit affirmed the dismissal of a complaint under Rule 9(b), the principal allegation of which was the failure to disclose that the resignation of a principal of the corporation was a "major loss" to the corporation. Noting that "[t]he complaint contains no factual allegations that would support a reasonable inference that adverse circumstances existed at the time of the offering . . . ," and alleged only that one of the corporate defendants "was in poor financial condition" (*Id.* at 879), the court held that dismissal of the complaint was appropriate. There is therefore little doubt that the complaint in *Romani,* like the complaint in *Denny,* would not have passed muster under the decision of the Court of Appeals below.

Likewise, in *DiLeo,* the Seventh Circuit [relying upon the same Third Circuit decision in *Christidis v. First Pennsylvania Mortgage Trust,* 717 F.2d 96 (3d Cir. 1983), as the Court of Appeals here specifically did] affirmed the dismissal of a securities complaint against an auditing firm charged with violations of the federal securities laws in connection with inaccuracies in a financial

B. *The Ruling Of The Court of Appeals Below Is Entirely Consistent With Prior Decisions Of The Court of Appeals For The Third Circuit*

In a further effort to create the illusion that the decision of the Court of Appeals below should be reviewed by this Court, Petitioners make the remarkable argument that the Court of Appeals' decision is somehow "inconsistent" with two other Third Circuit's opinions, which affirm the dismissal of securities complaints, *Decker v. Landmark Savings Ass'n,* No. 91-3776 (3d Cir. May 20, 1992), and *Christidis v. First Pennsylvania Mortgage Trust,* 717 F.2d 96 (3d Cir. 1983). Petitioners are wrong.

As a threshold matter, a claimed conflict among decisions of different panels of a Court of Appeals is not a consideration justifying the grant of a writ of *certiorari. See Davis v. United States,* 417 U.S. 333, 340 (1974) ("decisions between different panels of the same Court of Appeals will not be considered to present a reviewable conflict, since such differences are deemed an intramural matter to be resolved by the Court of Appeals itself.").; Supreme Court Rule 10.

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institution's audited financial statements. *DiLeo* was the last of several securities lawsuits arising from large loan writeoffs by Continental Illinois Bank. The other cases included a securities fraud suit which produced a substantial settlement, and an action brought by the FDIC that culminated in a full trial examining the merits of Ernst & Whinney's role in the events leading up to the large loan writeoffs. *DiLeo,* 901 F.2d at 625. The Seventh Circuit thus held the *DiLeo* complaint to an especially high standard for pleading fraud with particularity because the many investigations and litigations caused a "flood of information" to be released about Continental Bank and that information "offer[ed] ample fodder if there [was] indeed a tale to tell." *DiLeo,* 901 F.2d at 627. Thus, it is apparent that the decision of the Court of Appeals in *DiLeo* turns principally on the fact that there were no facts relevant to the plaintiff's claim that were in the exclusive possession of the defendants, and yet, the plaintiffs had alleged nothing more than a "boiler plate" complaint, which would clearly have been dismissed under the formulation of the Court of Appeals below.

In any event, there is no conflict. In *Landmark*, a panel of the Third Circuit entered an unpublished, one paragraph Judgment Order affirming a five paragraph District Court Order, which in turn affirmed a Magistrate Judge's Report and Recommendation urging the dismissal of a complaint charging a financial institution and its directors with violations of the federal securities laws, for "essentially" the same reasons as the Magistrate Judge. The Third Circuit's unpublished Judgement Order in *Landmark* has no precedential value under the Internal Operating Procedures of the Third Circuit.[3] It is therefore nothing short of astonishing and disingenuous that Petitioners in their attempt to concoct an intra-Circuit conflict repeatedly refer in their Petition to the Third Circuit's non-existent "opinion" in *Landmark* and attempt to pass off the Report and Recommendation of the Magistrate Judge as that of the Third Circuit. The fact of the matter is that there was no Third Circuit "opinion" in *Landmark*. Nor did the Third Circuit "acknowledge" or "reaffirm" (Pet. at 20) anything in *Landmark* other than that the case warranted disposition, by way of a one paragraph judgment order, for "essentially"

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3. Internal Operating Procedure ("IOP") 5.5.2 of the Third Circuit provides as follows:

> *Per curiam opinions, memorandum opinions, and judgment orders.* Per curiam opinions are not published as provided in IOP 5.6.1 unless the panel or court in banc, as the case may be, expressly directs publication. *Judgment orders and memorandum opinions are never published.* (emphasis added).

Third Circuit IOP 5.6 expressly provides that *"[b]ecause only published opinions have precedential value, the court does not cite to its unpublished opinions as authority."* (emphasis added). IOP 6.2.1 provides:

> *A judgment order is filed when the panel unanimously determines* to affirm the judgment or order of the district court or decision of the Tax Court, enforce or deny review of a decision or order of an administrative agency or dismiss the appeal or petition for review for lack of jurisdiction or otherwise, and determines *that a written opinion will have no precedential or institutional value.* (emphasis added).

the same reasons as those expressed by Magistrate Judge. The *Landmark* judgment order cannot serve as the basis of any claimed "intra-Circuit conflict" with the forty five (45) page decision of the Court of Appeals below, as the full Third Circuit, sitting *en banc*, recognized in denying Petitioners' petition for rehearing *en banc* based on the precise "intra Circuit" conflict argument based on the *Landmark* judgment order as Petitioners now raise herein. (A-51 - A-52)

Similarly without merit is Petitioners' argument that the decision of the Court of Appeals below somehow conflicts with the decision of the Third Circuit in *Christidis v. First Pennsylvania Mortgage Trust,* 717 F.2d 96, 99 (3d Cir. 1983), where the court affirmed the dismissal of a federal securities complaint against a financial institution and its directors charging the overstatement of reported income and the understatement of loan loss reserves, because the plaintiff had not alleged "the manner in which, in establishing reserves for bad debts in the financial statements relied upon, defendants knowingly departed from reasonable accounting practices," and "what those practices are and how they were departed from." 717 F.2d at 100. In fact, the Court of Appeals below scrupulously adhered to the teachings of the *Christidis* panel in articulating the pleading standards required by Rule 9(b), and emphasized that the *Christidis* standards were "stringent." (A-23). Indeed, the Court cited and quoted extensively from the *Christidis* decision in connection with its discussion of Rule 9(b) standards:

> Rule 9(b) requires a plaintiff to plead (1) a specific false representation of material fact; (2) knowledge by the person who made it of its falsity; (3) ignorance of its falsity by the person to whom it was made; (4) the intention that it should be acted upon; and (5) that the plaintiff acted upon it to his damage. *Christidis v. First Pennsylvania Mortgage Trust,* 717 F.2d 96, 99 (3d Cir. 1983).

> Despite these stringent requirements, the courts should be "sensitive" to the fact that application of the Rule prior to discovery "may permit sophisticated defrauders to successfully conceal the details of their fraud." *Id.* at 99-100. They should also respect the "general simplicity and flexibility" of the Federal Rules of Civil Procedure. *Id.* at 100.

(A-23).

The Court of Appeals' decision below is thus entirely consistent with *Christidis* and is also consistent with the Third Circuit's more recent decision in *In re Craftmatic Securities Litigation*, 890 F.2d 628, 645 (3d Cir. 1989) where the Court – like the panel below – specifically referred to *Christidis*, holding that "[c]ourts must be sensitive to the fact that application of Rule 9(b) prior to discovery 'may permit sophisticated defrauders to successfully conceal the details of their fraud' " and should therefore apply Rule 9(b) "flexibly" (890 F.2d at 645) and further held:

> Under a flexible application of Rule 9(b), plaintiffs need not necessarily allege the specific information at defendants' disposal at the time the alleged misrepresentations were made. However, plaintiffs must accompany their allegations with facts indicating why the charges against defendants are not baseless and why additional information lies exclusively within defendants' control.

890 F.2d at 646.

So too in this case, as in *Christidis* and *Craftmatic*, did the Court of Appeals direct that although courts should take a plaintiff's access to non-public details of the alleged fraud into account in assessing the sufficiency of his allegations of fraud, the complaint must nonetheless allege the circumstances of the fraud specifically. In fact, the Court of Appeals in this case went even further and added an additional safeguard against pleading abuse by requiring the plaintiff to allege the

details of his investigation of the alleged fraud, according to the Court of Appeals, "to ensure that plaintiffs thoroughly investigate all possible sources of information, including but not limited to all publicly available information, before filing a complaint." (A-24).

Thus, it is apparent that the decision of the Court of Appeals below does not in any way conflict with prior decisions of the Third Circuit concerning standards to be applied under Rule 9(b).

IV. THE COURT OF APPEALS BELOW HELD THAT STATEMENTS OF MATERIAL FACTS BY CORPORATE OFFICERS AND DIRECTORS MUST BE TRUTHFUL, A RULING ENTIRELY CONSISTENT WITH THE PRECEDENTS OF THIS COURT AND WITH THE POLICIES UNDERLYING THE SECURITIES LAWS

In the final two paragraphs of their Reasons For Granting The Writ, Petitioners contend that an additional reason why certiorari should be granted is that the Court of Appeals held that the fact that a corporate director makes any public statement, in and of itself, makes that statement "material" within the meaning of the federal securities laws, thereby "ignoring" this Court's decisions defining the standard of materiality.

Defendants' argument is a gross distortion of the ruling of the Court of Appeals, which did *not* hold that the mere fact that a corporate officer or director makes a statement automatically makes that statement "material." Instead, the Court of Appeals undertook a lengthy and rigorous analysis before arriving at the conclusion that certain of the statements alleged by plaintiffs could be material, and relied upon "an extensive review of the Supreme Court's jurisprudence on materiality." (A-15). The Court of Appeals expressly reaffirmed, applying the precedents of this Court, that a fact is material within the meaning of the federal securities laws only if, after a "delicate assessment[] of the inferences a reasonable

shareholder would draw from a given set of facts," "there is a 'substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder' " and "there is a substantial likelihood that the disclosure would have been viewed by the reasonable investor as having significantly altered the "total mix of information available to that investor." (A-16) (quoting *TSC Industries, Inc. v. Northway, Inc.*, 424 U.S. 438, 449 (1976)). The Court of Appeals thus undertook the precise rigorous, fact intensive materiality analysis that has been mandated by this Court.

Having found, under the analysis mandated by this Court in *TSC v. Northway, Inc.*, that certain of the allegations of the Complaint alleged misstatements of material facts,[4] the Court of Appeals went on to observe that its decision was "supported by" this Court's decision in *Virginia Bankshares, Inc. v. Sandberg*, ____ U.S. ____, 111 S.Ct. 2749 (1991). (A-18). As the Court of Appeals recognized in a three-page analysis of that decision, this Court in *Virginia Bankshares* reaffirmed the materiality standard of *TSC Industries, Inc.*, and held that under that standard statements of a corporation's officers and directors in a proxy statement recommending shareholder approval of a merger by describing the terms of the merger as "fair" and high" were material in that there was a substantial likelihood that a reasonable shareholder would consider such statements important in deciding how to vote on the merger. *Virginia Bankshares*, 111 S.Ct. at 2757. This Court in *Virginia Bankshares* further stated that:

> We have no occasion to decide whether the directors were obligated to state the reasons for their support of the merger proposal here, *but there can*

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4. Following this same fact-intensive analysis mandated by this Court's rulings, the Court found that several of the complaint's allegations *did not* set forth proper claims under the securities laws. See A-17.

> *be no question that the statement they did make carried with it no option to deceive.*

Virginia Bankshares, 111 S.Ct. at 2761 & n.7 (emphasis added).

Having found that the statements of defendants below could be found to be material, the Court of Appeals then simply followed the rulings of this Court in *Virginia Bankshares* and *TSC Industries, Inc.* that when a defendant makes a statement of fact that is material, it is "bound to speak truthfully." (A-18).

Petitioners cannot seriously argue that the Third Circuit is wrong in concluding that statements of material fact by corporate officers and directors must be truthful. It is a fundamental principle of the securities laws that material representations must not be false or misleading. *See Basic, Inc v. Levinson*, 485 U.S. 224, 238 (1988). Petitioners' argument that the Court of Appeals below "ignored" this Court's decision in *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) simply makes no sense. First of all the Court of Appeals specifically cited *Basic*. (A-21). Moreover, *Basic* concerned when a company is obligated to disclose the existence of merger discussions. See 485 U.S. at 236-241. *TSC Industries, Inc.* and *Virginia Bankshares*, which were relied upon by the Court of Appeals below, defined the standards to be applied in determining the "materiality" of statements by corporate insiders. The Court of Appeals opinion dealing with materiality is entirely consistent with *TSC Industries, Inc.*, *Virginia Bankshares* and *Basic* as well.[5] There is, then, no conflict between the

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5. While Petitioners contend wrongfully that the Court of Appeals "ignored" *Basic*, even they do not try to argue that the decision conflicts with *Basic* nor can they credibly so argue. Indeed, in *Basic*, this Court "expressly adopt[ed] the *TSC Industries* standard of materiality for the §10(b) and Rule 10b-5 context," 108 S.Ct. at 983, and reaffirmed that "materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information." *Id.* at 988. Of course, the Court of Appeals below expressly applied the standard of materiality articulated by

opinion below and this Court's prior holdings.

CONCLUSION

For all of the foregoing reasons, the petition for a writ of certiorari should be denied.

Dated: September 10, 1992

Respectfully submitted,

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NOTES *(Continued)*

this Court in *TSC Northway* in assessing the materiality of the facts alleged by Respondents here to be false and misleading (A-16). The Court of Appeals decision on materiality also scrupulously followed this Court's admonition in *Basic* that, even if a corporation is under no duty to volunteer material information, it is not free to lie once if it chooses to comment concerning that material information. 108 S.Ct. at 987-98. This is precisely what the Court of Appeals ruled here, i.e. "if a defendant has not commented on the nature and quality of the management practices that it has used to reach a particular statement of loan loss reserves, earning, assets or net worth, it is not a violation of the securities laws to fail to characterize these practices as inadequate, meaningless, out of control or ineffective. . . . However, where a defendant affirmatively characterizes management practices as "adequate, 'conservative,' 'cautious' and the like, the subject is 'in play' " and the defendant "thus is bound to speak truthfully." (A-17-18).

No. 92-267

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1992

UJB FINANCIAL CORP., et al.,

Petitioners,

v.

IRWIN SHAPIRO, ROBERT BASSMAN, JEROME KATZ, NORMAN SALTSITZ, JEAN LEE, and CHAPPAQUA FAMILY TRUST,

Respondents.

Petition for a Writ of *Certiorari* to the United States Court of Appeals for the Third Circuit

RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF *CERTIORARI*

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QUESTIONS PRESENTED FOR REVIEW

1. Do the factual allegations of the complaint allege fraud with sufficient particularity as required by Rule 9(b) of the Federal Rules of Civil Procedure?

2. Do officers and directors of a corporation have a duty under the federal securities laws to speak truthfully when making material representations concerning the corporation's internal affairs?

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No. 92-267

In The

Supreme Court of the United States

October Term, 1992

UJB FINANCIAL CORP., et al.,

Petitioners,

v.

IRWIN SHAPIRO, ROBERT BASSMAN, JEROME KATZ, NORMAN SALTSITZ, JEAN LEE, and CHAPPAQUA FAMILY TRUST,

Respondents.

Petition for a Writ of *Certiorari* to the United States Court of Appeals for the Third Circuit

RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF *CERTIORARI*

Respondents Robert Bassman, Jerome Katz, Norman Saltsitz, Jean Lee, and Chappaqua Family Trust (collectively, "Respondents") submit this brief in opposition to the petition for a writ of *certiorari*[1] filed on behalf of UJB Financial Corp. ("UJB") and certain of its officers and directors (collectively, "Petitioners"). Petitioners ask this Court to review an individual complaint to determine

[1] Respondent Irwin Shapiro is filing a separate brief in opposition to the petition for a writ of *certiorari*.

whether that complaint satisfies the pleading requirements of Rule 9(b) of the Federal Rules of Civil Procedure. Contrary to Petitioners' claims, there is no new standard, conflict, or confusion that warrants this Court's intervention in this litigation. The petition for a writ of *certiorari* should, therefore, be denied.

STATEMENT OF THE CASE

The petition for a writ of *certiorari* concerns Respondents' consolidated complaint on behalf of a class of purchasers of UJB common stock.[2] Respondents allege that in violation of §§ 11, 12, and 15 of the Securities Act of 1933, and §§ 10(b), 14(a), and 20 of the Securities Exchange Act of 1934 Petitioners misrepresented and omitted to disclose material information in their public statements concerning UJB. In particular, Respondents allege, on information and belief, that Petitioners knowingly or recklessly misrepresented the adequacy of UJB's provisions for loan losses, and the quality and effectiveness of UJB's procedures for monitoring loans and for ensuring that there were adequate reserves for potential problem loans.[3]

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[2] The complaint that Petitioners attack is Respondents' *first* consolidated complaint, and not Respondents' fourth complaint, as Petitioners misleadingly claim. *See* Pet. at 4.

[3] The opinion below, which is reproduced in the Appendix accompanying the petition for writ of *certiorari* at A-1 through A-35, contains a more detailed description of Respondents' allegations, including direct quotations of important portions of

Petitioners attacked Respondents' complaint in the District Court on several fronts. Petitioners sought dismissal pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure for failure to state a claim upon which relief can be granted, and claimed that the complaint does not allege fraud with particularity sufficient to satisfy Rule 9(b) of the Federal Rules of Civil Procedure. The District Court, in response to Petitioners' motion, dismissed Respondents' complaint. According to the District Court, certain of the complaint's allegations failed to plead violations of federal law, while others failed to allege with particularity fraudulent conduct. (*See* A-38-50.)

On appeal, the Court of Appeals for the Third Circuit affirmed the District Court's judgment in part, reversed it in part, and remanded the case to the District Court. *See Shapiro v. UJB Financial Corp.*, 964 F.2d 272 (3d Cir. 1992) (A-1-35). The Court of Appeals agreed with the District Court's determination that portions of Respondents' complaint failed to state claims under the federal securities laws. However, the Court of Appeals also determined that when the complaint is examined against controlling precedent, particularly this Court's decision in *Virginia Bankshares, Inc. v. Sandberg*, 111 S. Ct. 2749 (1991), aspects of Respondents' complaint did state claims under federal law. In this regard, the Third Circuit, adhering to this Court's decision in *Virginia Bankshares*, noted that where

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Respondents' consolidated complaint. Respondents respectfully refer the Court to the opinion of the court below for further detail concerning Respondents' allegations. (*See* A-3 to A-10.)

corporate officers comment on the internal affairs of a corporation, these comments are likely to be material to investors, given corporate insiders' superior access to information and the importance that investors place on corporate insiders' statements. The Third Circuit, again consistent with this Court's holdings, repeated what is a fundamental truth in the realm of federal securities laws: when corporate insiders speak on material matters, they must speak truthfully. (*See* A-17-22.)

With respect to Petitioners' attacks below on the specificity of Respondents' complaint, the Court of Appeals concluded that the complaint lacked allegations sufficient to satisfy Rule 9(b)'s pleading requirements. In assessing the particularity of Respondents' complaint, the Court of Appeals noted, unremarkably, that oftentimes in the context of a securities fraud action, the operative facts are exclusively in the defendants' possession, a circumstance that inhibits a plaintiff from alleging the underlying facts on personal knowledge and to an exacting degree of particularity. (*See* A-22-25.) Courts in and out of the Third Circuit, recognizing this circumstance, have for decades allowed plaintiffs to plead fraud on information and belief where the underlying facts are within the defendants' exclusive knowledge or control, provided that the plaintiffs provide a statement of facts upon which their information and belief is founded. *See, e.g., In re Craftmatic Sec. Litig.*, 890 F.2d 628, 646 (3d Cir. 1989); *Duane v. Altenburg*, 297 F.2d 515, 518 (7th Cir. 1962). The Third Circuit, in its opinion below, emphasized that a plaintiff must still allege in detail all efforts that he made to uncover specific facts to support any information and belief that fraud has occurred. The Court of Appeals

concluded that Respondents' complaint failed to include this necessary detail. (*See* A-23-25.)

The court below specifically ordered Respondents to redraft their complaint. In the Court of Appeals's view, Respondents' complaint intermingled actionable and inactionable claims. Respondents, therefore, are required to reorganize their complaint, without adding new information, to allow for an assessment of the allegations that the Third Circuit found to be actionable. (*See* A-22.) Further, because the complaint did not contain allegations required to satisfy Rule 9(b), Respondents must add specific allegations concerning their efforts to uncover facts in support of the alleged fraud. (*See* A-24-25.) Thus, Petitioners ask this Court to review prematurely a complaint that the Court of Appeals has ordered plaintiffs to rewrite.

REASONS WHY THE PETITION SHOULD BE DENIED

Petitioners have failed to demonstrate that there is any need for this Court to review the Third Circuit's decision. The decision below represents neither a departure from prior case law, nor a conflict with case law applicable in every Circuit in the United States. Further, the court below did not determine that any of Respondents' allegations were sufficiently particular. In fact, the court below ordered Respondents to rewrite their complaint.

1. THE THIRD CIRCUIT'S HOLDING CONCERNING RULE 9(b) DOES NOT CREATE A CONFLICT AMONG THE CIRCUITS, WITHIN THE THIRD CIRCUIT, OR CONFUSION AMONG THE DISTRICT COURTS

Petitioners expend considerable energy in an effort to conjure up a conflict to justify their seeking a writ of *certiorari*. The proffered conflicts, however, are all illusions.

Petitioners premise their claims that this Court's intervention is necessary on a distorted interpretation of the opinion below, which they claim substantially lowers a pleader's burden under Rule 9(b). However, the opinion below is quite unremarkable in its limited conclusion that a pleader must allege all investigative efforts in detail before a court can, in applying Rule 9(b), consider whether facts are peculiarly within an adverse party's control.

Petitioners, having obscured the plain meaning of the opinion below, take their distorted interpretation and compare it to decisions of the First, Second, and Seventh Circuits and to an order of a separate Third Circuit panel to create the illusion of conflicts. Also, Petitioners juxtapose a range of district court decisions on the application of Rule 9(b) to individual complaints and use the crafted array of results to create an illusion of what they claim is "confusion." However, when the smoke, mirrors, and manipulation are cleared away, it is apparent that there are no conflicts, whether inter- or intra-Circuit, and that Petitioners have demonstrated nothing more than a difference in results attributable to variations in the factual patterns in which cases arose.

a. The Third Circuit Did Not Deviate From Existing Interpretations of Rule 9(b)

In assessing Petitioners' request that this Court review the Third Circuit's decision, it is important to focus upon what the court below actually held, as distinguished from Petitioners' embellished contortion of the Third Circuit's conclusion. The Third Circuit *did not* conclude, as Petitioners claim, that a plaintiff can satisfy Rule 9(b)'s particularity requirement simply by alleging that the facts underlying the asserted fraud are peculiarly within the adverse party's control, and that the plaintiff has undertaken as complete an investigation as possible. The Third Circuit determined only that, where a pleader seeks to have a court take into consideration that the facts concerning an alleged fraud are within the exclusive control of the adverse party in determining whether the pleader has alleged fraud in compliance with Rule 9(b), the pleader must specifically allege any efforts to obtain the facts. (*See* A-24.) In concluding that Respondents' complaint as drafted does not satisfy Rule 9(b), the court below emphasized that even where facts are peculiarly within the possession and control of an adverse party, a plaintiff must still provide a specific factual basis to support his allegation. (*Id.*) *See* Jay B. Kasner, Rita W. Gordon, *Shareholder Suits: Ruling a Victory for Banks,* American Banker, August 5, 1992, at 4 ("Significantly, . . . the appeals court reaffirmed that plaintiffs must specifically provide a factual basis for their allegations of fraudulent conduct . . . .").

This interpretation of Rule 9(b) is not new. Courts in the Third Circuit have recognized for years that Rule 9(b)

must be applied flexibly where an adverse party is in control of all the facts. *See, e.g., Denny v. Carey,* 72 F.R.D. 574, 580 (E.D. Pa. 1976); *cf. Chambers Development Co. v. Browning-Ferris Indus.,* 590 F. Supp. 1528, 1539 (W.D. Pa. 1984) (granting plaintiff an opportunity to take discovery for 60 days to amend RICO allegations where information concerning mail or wire fraud was in adverse party's control); *Eaby v. Richmond,* 561 F. Supp. 131, 137 (E.D. Pa. 1983) (same). In *Christidis v. First Pennsylvania Mortgage Trust,* 717 F.2d 96 (3d Cir. 1983), from which Petitioners claim the decision below deviates, the Third Circuit specifically noted that:

> In applying the first sentence of Rule 9(b) courts must be sensitive to the fact that its application, prior to discovery, may permit sophisticated defrauders to successfully conceal the details of their fraud. Moreover, in applying the rule, focusing exclusively on its "particularity" language "is too narrow an approach and fails to take account of the general simplicity and flexibility contemplated by the rules."

Id. at 99-100 (quoting 5 Charles Alan Wright & Arthur R. Miller, *Federal Practice and Procedure,* § 1298 at 407 (1969)).

Following *Christidis,* the Third Circuit, in its decision in *In re Craftmatic Sec. Litig.,* 890 F.2d 628 (3d Cir. 1989), reaffirmed that Rule 9(b) must be applied flexibly, but that even under a flexible approach, a pleader must adduce facts sufficient to support a claim of fraud. As the court explained:

> Under a flexible application of Rule 9(b), plaintiffs need not necessarily allege the specific information at defendants' disposal at the time

> the [alleged misrepresentations] were made. However, plaintiffs must accompany their allegations with facts indicating why the charges against defendants are not baseless and why additional information lies exclusively within defendants' control.

Id. at 646.

The opinion below is indistinguishable from the Third Circuit's conclusions in *Christidis* and *Craftmatic*. In all three cases, the Third Circuit recognized that a pleader's inability to access facts is to be considered in evaluating whether fraud has been pleaded with sufficient specificity. The opinion below only emphasizes that a pleader must disclose his investigative efforts before a court can evaluate whether, under the circumstances, there is sufficient particularity to comply with Rule 9(b)'s dictates. (*See* A-23-24.)

b. There is No Intra-Circuit Conflict That Requires Resolution

Petitioners contend that this Court's review is necessary to resolve a conflict between the opinion below and a summary affirmance by a separate Third Circuit panel of a District Court's order, which, in turn, was a summary affirmance of a Magistrate's Report and Recommendations. Even the most cursory comparison of the supposedly "conflicting" decisions belies Petitioners' contention.

On May 20, 1992, the day on which the Third Circuit issued its opinion in this case, a separate panel of that court affirmed, with a judgment order, the District Court's dismissal of the complaint in *Decker v. Landmark Savings*

Assoc., No. 91-3776, slip op. (3d Cir. May 20, 1992) (judgment order) (A II-6). In *Landmark*, the District Court, in a memorandum order, affirmed a Magistrate's Report and Recommendations. (*See* A II-7.) Thus, according to Petitioners, a one paragraph judgment order summarily affirming, without any analysis or explanation, a five paragraph memorandum order, which likewise lacked any real explanation, affirming a Magistrate's recommendations creates a conflict with a separate panel of the Third Circuit, which issued a multi-page decision detailing its reasoning. Apart from the fact that under the Third Circuit's Internal Operating Procedures, a judgment order is never published and, therefore, lacks any value as a precedent, *see* Third Cir. Int. Op. Pro. 5.5.2 and 5.6, to characterize Petitioners' claim as overreaching is to be charitable.[4]

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[4] There are two curious aspects to Petitioners' argument in this regard. First, in quoting the Third Circuit's judgment order in their petition, Petitioners exclude a critical word: "essentially." Contrary to Petitioners' claim, the judgment order does not affirm the dismissal of the *Landmark* complaint for the "*same* reasons" as those recommended by the Magistrate, but for "*essentially* the same reasons." (A II-6 (emphasis added).)By qualifying its judgment order with the word "essentially," the Third Circuit panel left substantial doubt as to the precise reasons for its affirmance. From the judgment order, it is impossible to tell what parts of the Magistrate's reasoning the panel did and did not endorse. Moreover, the rationale underlying the Magistrate's two Reports and Recommendations are themselves somewhat difficult to discern, to the extent that issues concerning Rule 9(b) are intermingled with issues concerning arguable failures to state claims upon which relief can be granted.

Second, Petitioners, although they claim that the *Landmark* complaint and the complaint in this litigation are similar, have failed to submit a copy of either complaint as part of the Appendix. Petitioners' failure to submit either Respondents' complaint or the *Landmark* complaint causes one to ask what Petitioners

That there is no conflict between the two panel decisions is underscored by the fact that the Third Circuit rejected Petitioners' petition for rehearing *en banc*, in which Petitioners posited the same illusory "conflict" that they present here. (*See* A-51-52.) If the judges of the Third Circuit believed there is a conflict between this case and *Landmark*, they would have sought to resolve it.[5] They did not, and denied Petitioners' petition for rehearing.

c. The Circuits Are Uniform in Considering Whether Facts Are in the Exclusive Possession of an Adverse Party in Applying Rule 9(b)

Petitioners rely principally upon three decisions to create their claimed inter-Circuit conflict: *Romani v. Shearson Lehman Hutton*, 929 F.2d 875 (1st Cir. 1991), *DiLeo v. Ernst & Young*, 901 F.2d 624 (7th Cir.), *cert. denied*, 111 S.

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are trying to hide. The answer is simple: that decisions concerning the application of Rule 9(b) turn on the allegations peculiar to any complaint. The Magistrate's Report and Recommendations in the *Landmark* case makes clear that the recommendation to dismiss pursuant to Rule 9(b) is grounded entirely on the allegations in that case. The standard that the Magistrate applied to reach her conclusion is no different than the standard applied in the Third Circuit before and after the opinion below. (*See* A II-18-23 (applying standards set out in *In re Craftmatic Sec. Litig.*).)

[5] In any event, even if it is assumed that there is a conflict, it is a conflict that the Third Circuit in the first instance should resolve. *Cf. Davis v. United States*, 417 U.S. 333, 340 (1974) (noting previous denial of *certiorari* despite acknowledged conflict between two decisions of a single circuit).

Ct. 347 (1990), and *Denny v. Barber*, 576 F.2d 465 (2d Cir. 1978). According to Petitioners, these three decisions establish that the First, Second, and Seventh Circuits apply Rule 9(b) differently than does the Third Circuit in the decision below. These three decisions, however, do nothing of the sort.

With respect to the First and Second Circuits, Petitioners themselves concede that "these courts have relaxed somewhat the rigorous pleading standard under Rule 9(b) where the plaintiff has alleged that the facts lie solely within defendants' control. *See, e.g., DiVittorio v. Equidyne Extractive Indus., Inc.*, 822 F.2d 1242, 1217 [sic] (2d Cir. 1987); *Wayne Investments [sic] v. Gulf Oil Corp.*, 739 F.2d 11, 13-14 (1st Cir. 1984)." (Pet. at 14.) This concession is fatal to Petitioners' claim that there is any conflict between the First and Second Circuits and the decision below.[6]

The First Circuit's *Romani* decision is, in any event, squarely consistent with the decision below. The First Circuit, in *Romani*, stated that "[w]here allegations of fraud are explicitly or, as in this case, implicitly, based

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[6] Petitioners also cite 2A James W. Moore & Jo Desha Lucas, *Moore's Federal Practice* ¶ 9.03 [1], at 9-27-9-28 (2d ed. 1991) ("where the facts are in the exclusive possession of the adversary, courts should permit the pleader to allege the facts on information and belief, provided a statement of the facts upon which the belief is founded is proffered") in support of their contention that the application of Rule 9(b) in other Circuits is somehow different from the Third Circuit's approach. However, the Third Circuit, in its decision below, cited with approval this same passage from *Moore's*. (*See* A-24.) It is hard to conceive of a reason why the Third Circuit would rely on this passage from *Moore's* if it was expressing a thought inconsistent with *Moore's*.

only on information and belief, the complaint must set forth the source of the information and the reasons for the belief." *Romani*, 929 F.2d at 878. This statement is indistinguishable from the statements in the opinion below that Petitioners attack in their petition.[7] *Cf. New England Data Services, Inc. v. Becher*, 829 F.2d 286, 290-91 (1st Cir. 1987) (where specific information as to use of interstate mail or telecommunications for RICO claims "is likely in the exclusive control of the defendant," court should determine whether the plaintiff should have the opportunity to take discovery and then amend an otherwise defective complaint).

The Second Circuit cases too are indistinguishable from the decision below in terms of their analysis of Rule 9(b) where facts are within the exclusive control of an adverse party. *See, e.g., Wexner v. First Manhattan Co.*, 902 F.2d 169, 172 (2d Cir. 1990) (fraud allegations "may be based on information and belief when facts are peculiarly within the opposing party's knowledge," and complaint pleaded on information and belief must adduce specific supporting facts); *Ouaknine v. MacFarlane*, 897 F.2d 75, 81 (2d Cir. 1990) (concluding that allegations of scienter were sufficient where "allegations lie peculiarly within

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[7] In upholding the dismissal of a complaint for failing to plead fraud with the requisite specificity, the court in *Romani* conducted an inquiry concerning the specific allegations at hand. It upheld the dismissal because "[t]he complaint contains no factual allegations that would support a reasonable inference that adverse circumstances existed at the time of the offering, and were known and deliberately or recklessly disregarded by defendants." 929 F.2d at 878. Once again, the decision turned on the allegations of the particular complaint under consideration.

the opposing party's knowledge and are accompanied by information that raises a strong inference of fraud."); *Nicholas v. Poughkeepsie Savings Bank/FSB*, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,606 at 97,839-97,841 (S.D.N.Y. 1990) ("[T]he Second Circuit has repeatedly recognized that the requirements of Rule 9(b) are to be relaxed where the facts are 'peculiarly within the adverse party's knowledge.' ") (quoting *Segal v. Gordon*, 467 F.2d 602, 608 (2d Cir. 1972)).

The Second Circuit's decision in *Denny v. Barber* does not create a conflict between the Second and Third Circuits. In that case, the specific complaint at issue contained *no* allegedly misleading statements before the plaintiff's stock purchases. 576 F.2d at 468-69. In addition, the plaintiff alleged that the defendants failed to disclose the risks involved in certain investments that collapsed several years later. In upholding the dismissal of the complaint, the Second Circuit, in an opinion written by Judge Friendly, determined that the plaintiff had failed to allege how, other than through "greater clairvoyance," the defendants could possibly have known or forecast that future events would cause the investments to fail. *Id.* at 470. Nowhere do Petitioners explain how *Denny*, which does not address the application of Rule 9(b) where facts are in the exclusive possession of an adverse party, is more apposite than later Second Circuit decisions that explicitly discuss that situation.[8]

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[8] Petitioners, at several points, invoke *Denny's* "fraud by hindsight" language as part of their general hyperbolic reaction to the opinion below. *Denny's* "fraud by hindsight" language cannot be understood to preclude a plaintiff from relying on

The Seventh Circuit's decision in *DiLeo* also does not pose a conflict with the decision below. In *DiLeo*, the Court of Appeals upheld the dismissal of a Section 10(b) claim against an accounting firm that audited the financial statements of a financial institution, Continental Illinois. The plaintiffs in *DiLeo* alleged, *inter alia*, that Continental Illinois's loan loss reserves were inadequate and that Continental Illinois did not timely write off loans. The Court of Appeals held that the complaint in that case did not allege any facts that would establish that prior "rosy" statements were attributable to "fraud" simply because Continental Illinois later experienced losses and that the complaint alleged only " 'fraud by hindsight' ." 901 F.2d at 627-28 (quoting *Denny v. Barber*, 576 F.2d at 470)).[9] In so doing, the Seventh Circuit specifically noted

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later facts to establish that a defendant's previous representations are false or misleading. There is no inherent evil in a plaintiff basing allegations of fraud on subsequent disclosures concerning a business's internal affairs. As one court has written:

> [Where] the information directly involved the Bank's financial condition and business practices . . . it may be an appropriate inference that the nature and extent of the Bank's subsequent disclosures are evidence that the matters disclosed did not suddenly come to light.

Nicholas v. Poughkeepsie Savings Bank/FSB, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,606 at 97,841; *see also Robbins v. Moore Medical Corp.*, 788 F. Supp. 179, 192 (S.D.N.Y. 1992) ("[T]he *Denny* court recognized that fraud by hindsight decisions 'may or may not be consistent and . . . necessarily rest[ ] on [their] particular facts.' ") (quoting *Denny*, 576 F.2d at 470).

[9] Petitioners seize on the Seventh Circuit's statement in *DiLeo* that "[b]ecause only a fraction of financial deteriorations reflects fraud, plaintiffs may not proffer the different financial

that there had been a "flood" of public information, including several lawsuits and at least one full trial, from which the plaintiffs could have obtained relevant information to provide exacting detail for their complaint.

DiLeo does not present a conflict with the decision below because it is factually and legally inapposite. First, *DiLeo* involved an outside accounting firm, while the decision below involved corporate insiders. Courts have generally construed Rule 9(b) more stringently with respect to such third parties, *see, e.g., In re Frank B. Hall & Co., Inc.*, 693 F. Supp. 1460, 1462 (S.D.N.Y. 1988) ("*de facto* enhanced pleading requirement . . . has developed under Rule 9(b) . . . for outside professionals"); *Greenfield v. Professional Care, Inc.*, 677 F. Supp. 110, 114 (E.D.N.Y. 1987) ("when inside directors are involved inferences of fraud may be drawn that might otherwise not be permissible."). Second, as noted above, there had been a "flood of [public] information," including evidence presented publicly during a five month jury trial, regarding Continental Illinois and its financial condition *before* the *DiLeo* complaint was filed; in contrast, in this litigation, there was virtually no public information about UJB's internal

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statements and rest. Investors must point to some facts suggesting that the difference is attributable to fraud." *DiLeo*, 801 F.2d at 627 (cited in Pet. at 9). According to Petitioners, this quotation serves to crystalize the conflict between the Seventh and Third Circuits. As an initial matter, there is no conflict between the *DiLeo* court's conclusion that a pleader must "point to" facts suggesting that fraud has occurred and the Third Circuit's application of Rule 9(b). Moreover, the Seventh Circuit's premise, *i.e.*, that only a fraction of financial deteriorations reflects fraud, is an unsupported factual conclusion at which the Seventh Circuit arrived without citation.

financial condition that Respondents could access. In short, *DiLeo* and the decision below address two markedly different factual situations: fraud claims against corporate insiders where the underlying facts are exclusively within the adverse parties' possession (the decision below) as compared with fraud claims against outsiders where there is a substantial amount of publicly available information (*DiLeo*).

By contrast, 30 years ago, when the Seventh Circuit did address the same issue as addressed in the court below, it reached an identical conclusion:

> [P]leading on "information and belief" is permissible as to matters peculiarly within the adverse party's knowledge . . . [and] allegations of fraud such as are here involved when made on "information, and belief" must be accompanied by a statement of the facts upon which the belief is founded.

Duane v. Altenburg, 297 F.2d 515, 518 (7th Cir. 1962) (upholding dismissal of complaint that lacked statement of facts upon which information and belief was founded).

Indeed, it appears that the law on the specific issue addressed in the decision below is uniform throughout the land: where facts are peculiarly within an adverse party's knowledge, that circumstance is taken into consideration, *i.e.*, fraud may be pleaded on "information and belief," but pleaders "must accompany such an allegation with a statement of facts upon which their allegation is based." (A-24.) *See Scheidt v. Klein*, 956 F.2d 963, 967 (10th Cir. 1992) ("Allegations of fraud may be based on information and belief when the facts in question are peculiarly within the opposing party's knowledge and

the complaint sets forth the factual basis for the plaintiff's belief."); *Michaels Building Co. v. AmeriTrust Co., N.A.*, 848 F.2d 674, 680 (6th Cir. 1988) (noting that "[c]ourts have held that the rule may be relaxed where information is only within the opposing party's knowledge."); *Wool v. Tandem Computers Inc.*, 818 F.2d 1433, 1439 (9th Cir. 1987) (allegations of fraud may be upon information and belief where the plaintiff cannot have personal knowledge of the underlying wrongdoing; "[i]n such cases, the particularity requirement may be satisfied if the allegations are accompanied by a statement of the facts upon which the belief is founded."); *Kowal v. MCI Communications Corp.*, No. 90-2862 JGP, U.S. Dist. LEXIS 7437, at *21 (D.D.C. May 19, 1992) (allegations of fraud may be upon information and belief "as to matters peculiarly within the knowledge of the opposing party. . . . Even with respect to matters within the knowledge of the other party, the allegations must be accompanied by a statement of the facts upon which the belief is founded."); *U.S. ex rel. Stinson, Lyons, et. al. v. Blue Cross Blue Shield of Georgia, Inc.*, 755 F. Supp. 1040, 1052 (S.D. Ga. 1990) ("Where . . . factual information is peculiarly within the defendant's knowledge or control, rule 9 (b)'s requirement is relaxed somewhat. In such a case, pleading on information and belief is acceptable . . . but on one condition: the complaint must adduce specific facts supporting a strong inference of fraud or it will not satisfy even a relaxed pleading standard.") (citation omitted); *Burt on behalf of McDonnell Douglas v. Danforth*, 742 F. Supp. 1043, 1050 (E.D. Mo. 1990) ("[C]omplaining stockholders need not specify facts that are peculiarly within the opposing party's knowledge and more general allegations will suffice

as long as an attempt is made to comply with Rule 9(b) and the allegations are accompanied by a statement of the grounds on which the stockholder's belief rests.") (citations omitted); *Steiner v. Southmark Corp.*, 734 F. Supp. 269, 273 (N.D. Tex. 1990) (Rule 9(b) "may be relaxed . . . as to matter within the opposing party's knowledge. . . . In such cases, allegations satisfy Rule 9(b) if accompanied by a statement of the facts upon which the belief is based. . . . ") (citations omitted); *Sweeney Co. of Maryland v. Engineers-Constructors, Inc.*, 109 F.R.D. 358, 360 (E.D. Va. 1986) ("If plaintiffs do not have access to information, some relaxation of Rule 9(b) is necessary when plaintiffs are not likely to have more specific information until after discovery.") (citations omitted).[10] In short, Petitioners' asserted conflict does not exist as between the Third Circuit and any other court.

d. Rule 9(b) Decisions Involve Assessments of Individual Complaints

Petitioners' assertion that there is confusion at the district court level disregards the fact that, in the first

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[10] *See also Koch v. Koch Industries*, No. 85-1636-C, U.S. Dist. LEXIS 10952 (D. Kan. June 30, 1992); *In re VMS Sec. Litig.*, 752 F. Supp. 1373, 1391-92 (N.D. Ill. 1990); *Fairmont Homes, Inc. v. Shred Pax Corp.*, 754 F. Supp. 665, 667 (N.D. Ind. 1990); *F.D.I.C. v. Kerr*, 637 F. Supp. 828, 834 (W.D.N.C. 1986); *Texaco, Inc. v. Roberts*, No. 90-359, U.S. Dist. LEXIS 5180 (E.D. La. May 3, 1990); *Banowitz v. State Exchange Bank*, 600 F. Supp. 1466, 1469 (N.D. Ill. 1985); *cf. Seattle-First National Bank v. Carlstedt*, 800 F.2d 1008, 1011 (10th Cir. 1986).

instance, any determination of whether Rule 9(b)'s particularity requirement has been satisfied requires an assessment of the complaint at hand. The various cases that Petitioners attempt to contrast with each other (*see* Pet. at 10-11, 18-19) only underscore the point that Rule 9(b) requires a complaint specific determination of whether fraud has been pleaded with sufficient particularity.

The decision in *Urbach v. Sayles*, 779 F. Supp. 351 (D.N.J. 1991), illustrates the fact that the various decisions applying Rule 9(b), which Petitioners cite as evidence of "confusion," each turn almost entirely on the specific allegations of the particular complaint at hand, and not on any supposed variation in the standards for applying Rule 9(b). In that opinion, the District Court rejected arguments substantially similar to Petitioners' arguments here in ruling on a motion to certify an interlocutory appeal. In analyzing an alleged conflict between opinions applying Rule 9(b) at the district court level (a conflict that supposedly resulted from the decision in *Fox v. Equimark Corp.*, 782 F. Supp. 295 (W.D. Pa. 1991) and the District Court's opinion in this litigation (*See* A-38 to A51)), the District Court surveyed the authority on the application of Rule 9(b), including the Third Circuit's decisions in *Christidis*, 717 F.2d 96 (3d Cir. 1983), and *Craftmatic*, 800 F.2d 628 (3d Cir. 1989), the District Court's opinion in *Fox*, the Seventh Circuit's decision in *DiLeo*, 901 F.2d 624 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990), the Second Circuit's decision in *Denny*, 576 F.2d 465 (2d Cir. 1978), and the District Court's opinion in this litigation. The *Urbach* court concluded that all the opinions

applied similar standards in reaching their conclusions concerning Rule 9(b). *See* 779 F. Supp. at 358-64 ("Although the authorities cited by defendant rejected plaintiffs' fraud claims for failure to satisfy Rule 9(b), the showing of particularity there required is no different from the standard enunciated by this Court and satisfied by the plaintiff."). As the District Court's analysis in the *Urbach* case demonstrates, the purported "confusion" at the district court level is not confusion at all but, rather, is simply different results reached by different judges analyzing different complaints under the same Rule 9(b) standards. *See Robbins v. Moore Medical Corp.*, 788 F. Supp. at 191-92.

e. Whether the Complaint's Allegations Satisfy Rule 9(b)'s Particularity Requirement Does Not Warrant This Court's Attention

The issue of whether a complaint alleges fraud with sufficient particularity, as demonstrated above, turns upon the complaint's allegations and points up an additional reason for declining to issue a writ: Petitioners are asking the Court to review a single complaint, which the Court of Appeals already directed Respondents to rewrite, to determine whether that complaint satisfies Rule 9(b). This inquiry, which is manifestly premature and can be of interest only to the parties to this litigation, does not justify a writ of *certiorari*. *See Rice v. Sioux City Memorial Park Cemetery, Inc.*, 349 U.S. 70, 79 (1955) (writs should not be granted to settle principles of interest only to the parties as opposed to principles of interest to the public); *Layne & Bowler Corp. v. Western Well Works, Inc.*, 261 U.S. 387, 393 (1923). Whether the complaint in this litigation –

after it is rewritten and refiled as directed by the Third Circuit – ultimately pleads fraud with sufficient particularity will not resolve a dispute of sufficiently general application to warrant this Court's review. Other litigants and other courts will still have to answer for themselves whether, under the circumstances peculiar to the cases confronting them, Rule 9(b) has been satisfied.

Further, whether Respondents have satisfied Rule 9(b)'s particularly requirements is entirely speculative and hypothetical, given the Court of Appeals's direction that Respondents rewrite their complaint to excise inactionable allegations, to clarify their claims, and to add allegations injecting specificity as to their investigation of the fraudulent conduct at issue. Under these circumstances, this Court's limited resources should not be expended in an effort to determine whether an earlier version of Respondents' complaint satisfied Rule 9(b).

f. The Third Circuit's Decision Furthers Rule 9(b)'s Policies

Petitioners contend that this Court must intervene in this litigation because the decision below undercuts Rule 9(b)'s policies. However, the opinion below is entirely consistent with, and indeed furthers, those policies. The Third Circuit's requirement that a plaintiff specifically aver his efforts to uncover information allegedly in the exclusive control of an adverse party is not, as Petitioners characterize it, an endorsement of a "shoot first and ask questions later" approach to litigation. By requiring detailed allegations concerning a plaintiff's investigation of facts that the plaintiff claims cannot be reached, the

Third Circuit is ensuring that fraud claims are scrupulously examined before the commencement of litigation. (*See* A-24.) Further, even a party's scrupulous investigation cannot save a defective complaint if that scrupulous investigation does not yield the information and belief necessary to particularize allegations of fraud. *See Christidis*, 717 F. 2d at 100; *see also Michaels Building Co. v. AmeriTrust Co., N.A.*, 848 F.2d at 679-681.

2. THE THIRD CIRCUIT'S STATEMENT ON MATERIALITY IS CONSISTENT WITH THIS COURT'S DECISIONS

Petitioners, in addition to their attack on the Third Circuit's unremarkable discussion of Rule 9(b), claim that the discussion in the decision below of whether statements are actionable under the federal securities laws is somehow inconsistent with decisions of this Court. In particular, Petitioners assert that the Court below erred when it stated that "by addressing the quality of a particular management practice, a defendant declares the subject of its representation to be material to the reasonable shareholder, and thus is bound to speak truthfully" (A-18), because it purportedly "ignores" this Court's decision in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). It is Petitioners, however, and not the Third Circuit, who have ignored controlling precedent from this Court.

Petitioners' argument once again distorts the ruling of the court below. The statement that Petitioners attack flows from the Court of Appeals's analysis of whether certain alleged misstatements are actionable under the federal securities laws. In concluding that some are and

others are not, the court below did not hold that the fact that a corporate officer or director utters a statement automatically makes that statement material. The Court of Appeals simply recognized the significance that stock purchasers can place on corporate insiders' statements concerning internal corporate affairs about which insiders can be expected to have superior knowledge.

The court below's statement in this regard is nothing more than the logical application of this Court's conclusion in *Virginia Bankshares, Inc. v. Sandberg*, 111 S. Ct. 2749 (1991). In *Virginia Bankshares*, this Court stated:

> [T]here is no room to deny that a statement of belief by corporate directors about a recommended course of action, or an explanation of their reasons for recommending it, can take on . . . importance [to a reasonable shareholder in deciding how to vote]. Shareholders know that directors usually have knowledge and expertness far exceeding the normal investor's resources, and the directors' perceived superiority is magnified even further by the common knowledge that state law customarily obliges them to exercise their judgment in the shareholders' interest.

Id. at 2757.

As the court below explained, after quoting the above language:

> If a director's statement of belief is material because of the speaker's superior knowledge, then a manager's statement of belief must also be material. A manager's knowledge and expertise regarding the day-to-day operation of his company generally exceeds that of a director,

> and the reasonable investor is aware of this fact. Even if management sometimes acts in its own interest, a reasonable investor need not take a manager's statement of belief at anything less than face value.

(A-19.)

Petitioners no doubt are fully aware of this Court's *Virginia Bankshares* decision, particularly since it was cited and quoted in the opinion below. However, Petitioners totally ignore the *Virginia Bankshares* case (they do not even cite it in their petition) and instead look to this Court's holding in *Basic Inc. v. Levinson* in a feeble effort to manufacture another (non-existent) conflict.

Basic, though, is of no aid to Petitioners. This Court in *Basic* did not address the question of whether statements by a corporation's officers and directors about internal corporate affairs are actionable. Rather, *Basic* addresses only the question of when in the course of merger discussions the existence of such discussions becomes material and must be disclosed publicly. *See* 485 U.S. at 236-241. *Virginia Bankshares*, on the other hand, directly addresses the question of when affirmative statements by corporate directors become significant to reasonable investors. *Virginia Bankshares*, thus, provides the appropriate guidepost for assessing the Third Circuit's discussion of the potential importance of corporate insiders' comments. The Court of Appeals's statement is entirely consistent with *Virginia Bankshares*.

Further, Petitioners cannot question seriously the Third Circuit's statement that material statements by corporate officers and directors must be truthful. It is a

fundamental principle of securities law, of which Petitioners should have been aware from reading *Basic*, that material representations must not be false or misleading. *See Basic*, 485 U.S. at 238. There is, then, no conflict between the opinion below and this Court's prior holdings.

CONCLUSION

For the foregoing reasons, the petition for a writ of *certiorari* should be denied.

Dated: September 11, 1992

Respectfully submitted,

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No. 92-267

IN THE

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UJB FINANCIAL CORP., *et al.*,

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v.

IRWIN SHAPIRO, ROBERT BASSMAN, JEROME KATZ, NORMAN SALSITZ, JEAN LEE and CHAPPAQUA FAMILY TRUST,

Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Third Circuit

MOTION FOR LEAVE TO FILE BRIEF AND BRIEF OF THE AMICUS CURIAE AMERICAN BANKERS ASSOCIATION IN SUPPORT OF PETITIONERS

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MOTION FOR LEAVE TO FILE BRIEF AS AMICUS CURIAE

The American Bankers Association, a trade association representing the interests of the commercial banking industry, respectfully moves for permission to file the attached brief as amicus curiae in support of the Petition for a Writ of Certiorari filed by UJB Financial Corp., et al.

The consent of all parties to this action for filing the attached amicus curiae brief has been requested. The attorneys for the Petitioners have agreed to the

filing of the attached amicus brief. The attorneys for the Respondents have withheld consent.

The complaint in *Shapiro v. UJB Financial Corp.*, 964 F.2d 272 (3d Cir. 1992) is all too typical of the cookie cutter pleadings filed against banks in the wake of the downturn in the market for commercial real estate. Among the oft seen claims is the charge that a bank (or bank holding company) and its officers and directors have committed securities fraud by failing to "provide for adequate loan loss reserves." *Id.* at 276 n.6.

Because such suits—even when entirely meritless—are tremendously expensive for both the parties and the legal system as a whole, it is imperative that this Court provide guidance and emphasize that the lower courts must enforce Rule 9(b)'s requirements for adequately pleading facts to support securities fraud claims in the context of reserving against loan losses. This amicus believes that the Third Circuit adopted the wrong standard which will encourage the continued filing of such debilitating suits.

Amicus seeks to file the attached brief to emphasize the importance of this case to the banking industry and, in particular, to explain the accounting concept of reserving against loan losses which forms one of the central issues in the Respondents' complaint.

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September 11, 1992

QUESTION PRESENTED FOR REVIEW

Did the Third Circuit err in announcing a new, "relaxed" application of Rule 9(b), Fed. R. Civ. P., which flatly conflicts with the standards of the First, Second and Seventh Circuits, as well as the standard previously established by the Third Circuit (including as applied by a different panel of the Third Circuit on the same day)?

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MOTION FOR LEAVE TO FILE BRIEF AND BRIEF OF THE AMICUS CURIAE AMERICAN BANKERS ASSOCIATION IN SUPPORT OF PETITIONERS

INTEREST OF THE AMICUS CURIAE

The American Bankers Association ("ABA") is the principal national trade association of the commercial banking industry in the United States. It has members in each of the fifty states and the District of Columbia and represents bank of all types (national and state chartered banks) and sizes (money center,

regional and community banks). ABA members hold approximately ninety percent of all domestic assets in commercial banks located in the United States.

The matter decided by the Court of Appeals involves a legal issue of the utmost concern to the banking industry. As this Court is no doubt aware, certain segments of the United States economy have suffered through a lingering recession, particularly with respect to real estate. Compounding this economic downturn has been the widely reported perception that the banking regulators, particularly the Office of the Comptroller of the Currency, have become extremely strict during their examinations and have been requiring banks to increase their loan loss reserves. *See, e.g.*, Brookes, *Regulators Creating a Credit Crisis?*, Washington Times, May 3, 1990. When loan loss reserves are increased, it is as if the bank spent or lost that money at the time the reserves are set aside. That has an effect upon the net income of the bank and, ultimately, upon the market value of bank stock. It is easy, with benefit of hindsight, to claim that "adequate" loan loss reserves should have been set aside earlier so as to present a more "accurate" picture of the true value of a bank's stock. In fact, numerous shareholder suits have been filed against banks containing allegations of securities fraud because of losses in the banks' loan portfolio. *See*, Sands, *Lending Practices Land Banks in Court*, Washington Times, April 20, 1990, at C1. *See also*, Pitt and Groskautmanis, *Shareholder Suits Suggest Some Lessons*, Nat'l L. J., August 10, 1992, n.7 at 27 (discussing proliferation of class actions alleging securities law violations and noting Wall Street Jour-

nal article stating over 300 such suits had been filed in 1990-91.)

Because of the expense of such lawsuits and because it is impossible to run a bank if honest and reasonable business judgments are made into guarantees of positive investment results—or guarantees of costly litigation from shareholders charging those judgments were faulty—it is extremely important that courts be able to dismiss such suits which fail to plead facts demonstrating the fraudulent activity being charged, as opposed to simply showing that management failed to predict the future. The American Bankers Association files this brief to explain the concept of reserving against loan losses in order to help the Court assess the correctness of the Court of Appeals' decision.

REASONS FOR GRANTING THE WRIT

One of the key holdings below was that the Respondents could plead defendants' allegedly fraudulent failure to provide for adequate loan loss reserves without any supporting facts showing how such reserves were improperly set, and based solely on hindsight. This presents an important question of federal law which has not yet been addressed by the Court but should be: What is the standard for adequately pleading securities fraud under Fed. R. Civ. P. 9(b)?

The Third Circuit would permit plaintiffs in such suits to state that the facts which form the basis of the allegedly fraudulent activity lie exclusively within the defendants' control and thereby satisfy Rule 9(b)'s requirement that the circumstances constituting fraud be "stated with particularity." *Shapiro v. UJB Financial Corp.*, 964 F.2d 272, 285 (3d Cir. 1992). Rather

than repeating the arguments made by the Petitioners and other amici, this amicus believes that it would help the Court to review the meaning and purpose of the particular accounting concept involved in this case.

The allowance for loan losses appears on a balance sheet as a deduction from the value of a loan portfolio. Commentators have recognized several functions which could be served by the reserve. These include an experience function, catastrophe function, and a valuation function. Golembe Associates, *The Adequacy of Bad Debt Reserves for Banks—A Preliminary Study* at 2 (1972). *See, also,* Financial Accounting Standards Board, *Statement of Financial Accounting Concepts No. 6—Elements of Financial Statements* at 9134 (1985) (hereinafter FASB No. 6). The experience function assumes that the loan loss reserve is intended to absorb losses which can be expected to occur in a single average year and is achieved by averaging out actual loss experience from past years. It is viewed as producing "the lowest benchmark" for the loss reserve. T. Hardy, *The Allowance for Loan Losses: Fact or Fiction?* at 8 (June, 1986) (unpublished theses available at the American Bankers Association library).

In contrast to the experience function, a loan loss reserve based on the catastrophe function assumes that the allowance should enable the lender to withstand loan losses which would occur under unforeseen economic crises such as a depression. *Id.* This probably represents the upper limit on the amount of the reserve but would "artificially inflate the allowance amount and make it difficult for the public as well as bank management to evaluate the problems inherent in a loan portfolio." *Id.* at 9.

Somewhere between these two extremes is the notion of the loan loss reserve serving a valuation function. For example, FASB No. 6 states that some accounts on a balance sheet serve as valuation accounts (i.e., a separate item which reduces or increases the carrying amount of an asset). In this context the loan loss reserve would "represent a measure of all losses expected in a given loan portfolio through its liquidation in the ordinary course of business." T. Hardy, *supra*, at 10.

The guidance from the accounting profession makes it clear that the loan loss reserve is to serve a valuation function for financial reporting purposes. "The amount of [the loss reserve] can be considered reasonable when the allowance for loan losses . . . is considered by management to be adequate to cover estimated losses inherent in the loan portfolio." American Institute of Certified Public Accountants—Banking Committee, *Audits of Banks* at 61 (2d. ed. 1983).

As to when and in what amounts such losses need to be identified, the accounting standards recognize the difficulty of this undertaking. FASB Statement No. 5, for example, requires that the loss be probable and reasonably estimable before it is accrued. Financial Accounting Standards Board, *Accounting Standards—Current Text—General Standards* at § C59.105. (Losses from uncollectible receivables, *e.g.*, principal and interest on loans, shall be accrued when both conditions, probable and reasonably estimable, are met.) The banking regulatory guidance is similar. "It is not the examiner's responsibility to initially ascertain the amount of allowance, but rather to determine that management has exercised its responsibility to

use *reasonable* judgment based upon reliable information to arrive at an appropriate allowance." Office of the Comptroller of the Currency, *Comptroller's Handbook for National Bank Examiners* § 217.1 at 2 (1984) (emphasis added).

What is readily evident from the discussion above is the subjective process for arriving at the "correct" amount of loan loss reserves. Unlike such objective entries on a financial statement as inventory and sales, the amount stated for loss reserves is nothing more than an educated prediction of future events. Robert Morris Associates, *Managing the Allowance for Loan and Lease Losses State of the Art* at 11 (1988). This prediction will likely be based on a system which sets forth a particular method of evaluation (*e.g.*, frequency of review, documentation, minimum allowable allowance, identification of problem loans, allocation of loss for specific loans, etc.) but the decision ultimately remains a guess. *Id.* at 55-60.

As events play themselves out, and with 20-20 hindsight, the correctness of the loan loss reserve calculation can easily be evaluated. In today's economy, for example, it has become evident that some financial institutions failed to anticipate the extent of the difficulty which would be encountered by certain regions and within certain industries. But miscalculations of the loss reserve, even by a significant amount, do not, standing alone, represent fraudulent acts by the lending institution.

Shareholder suits, such as the one at issue in this case, typically make broad allegations of fraud based on the inadequacy of loss reserves and are primarily, if not exclusively, based on 20-20 hindsight. The argument made in such suits is that the bank's financial

disclosures state loan loss reserves which later prove to be "inadequate" and, therefore, constitute fraud under section 10(b) of the Securities Act of 1934. Plaintiffs typically demand broad discovery orders seeking the banks' loan files in an effort (again with the benefit of hindsight) to determine what the reserves "should have been."

Because of the expense of this type of litigation, it is extremely important for courts to hold plaintiffs to the requirement of Rule 9(b) that fraud claims be supported by allegations of fact pled with "particularity." *Billard v. Rockwell International Corp.*, 683 F.2d 51 (2d Cir. 1985) (Rule 9(b) will be strictly construed to minimize strike suits). In this case, for example, it is not an overwhelming burden to require the plaintiffs to identify specifically in what respect the loan loss reserves were false or misleading at the time the estimates were made. "[M]ere conclusory allegations of fraud are insufficient, statements of the time, place *and nature* of the alleged fraudulent activities are sufficient." *Wool v. Tandem Computers Inc.*, 818 F.2d 1433, 1439 (9th Cir. 1987) (emphasis added). *See*, *DiLeo v. Ernst & Young*, 901 F.2d 624, 627 (7th Cir.1990) (plaintiffs' complaint that bank's failure to increase reserves constituted fraud inadequate under Fed. R. Civ. P. 9(b) because circumstances of the fraud "the who, what, when, where and how" not specified). As the court noted in *Romani v. Shearson Lehman Hutton*, 929 F.2d 875 (1st Cir. 1991), "We have been especially rigorous in demanding such factual support in the securities context to minimize the chance 'that a plaintiff with a largely groundless claim will bring a suit and conduct extensive discovery in the hopes of obtaining an increased

settlement. . . .'" *Id.* at 878 (citations omitted). *See also, Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 741, *reh'g denied*, 423 U.S. 884 (1975) (threat of discovery may add "*in terrorem*" increment to settlement value).

Ironically, the Third Circuit itself has recognized the importance of meeting the pleading requirements of Rule 9(b) where allegedly inadequate loan loss reserves form the basis of the plaintiffs' securities fraud suit. The court, in *Christidis v. First Pennsylvania Mortgage Trust*, 717 F.2d 96, 100 (3d Cir. 1983), affirmed the dismissal of such a complaint because of "the complete absence of any disclosure of the manner in which, in establishing reserves for bad debts . . . the defendants knowingly departed from reasonable accounting practices." In this case, however, the Third Circuit merely plays lip service to *Christidis* before announcing its lesser pleading standard. In doing so the Third Circuit's crafting of a reduced pleading standard departs from the express requirements of Rule 9(b) and the application of the rule by other courts, sends the wrong signal to the plaintiff bar, and ignores the policies behind the heightened pleading requirement of Rule 9(b).

CONCLUSION

The amicus urges this Court to grant the petition for a writ of certiorari. The ruling below relaxes the standards for pleading in fraud cases and allows plaintiffs to pursue often groundless allegations and engage in discovery "fishing expeditions." If this Court allows the Third Circuit's rewriting of Rule 9(b) to stand, banks and other commercial enterprises are certain to continue to face unfounded charges of fraud

every time economic reversals cause investors to lose money.

Respectfully submitted,

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MOTION FOR LEAVE TO FILE BRIEF AS *AMICUS CURIAE* AND BRIEF OF THE NEW YORK CLEARING HOUSE ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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Supreme Court of the United States

October Term, 1992

No. 92-267

UJB FINANCIAL CORP., *et al.*,

Petitioners,

v.

IRWIN SHAPIRO, *et al.*,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

MOTION FOR LEAVE TO FILE BRIEF AS *AMICUS CURIAE*

The New York Clearing House Association (the "Clearing House") is an association of eleven commercial banks in the City of New York. The members of the Clearing House are The Bank of New York, The Chase Manhattan Bank, N.A., Citibank, N.A., Chemical Bank, Morgan Guaranty Trust Company of New York, Bankers Trust Company, Marine Midland Bank, N.A., United States Trust Company of New York, National Westminster Bank USA, European American Bank and Republic National Bank of New York. The banks of the Clearing House include some of the largest consumer and commercial banks in this country. The Clearing House

regularly appears as *amicus curiae* in cases raising important issues relating to the banking industry.

The Clearing House has requested the consent of all parties to this action for the filing of its brief as *amicus curiae*. Counsel for Petitioners has consented to the filing of the attached brief. Counsel for Respondents has withheld consent.

The complaint in this action resembles those filed in a multitude of other actions against banks and bank holding companies in the past several years. The underlying theory here—as in those cases—is that the defendants violated Rule 10b-5 by establishing inadequate loan loss reserves, thereby overstating assets and artificially inflating the price of the bank's stock. The complaint notes that loan loss reserves were once described as adequate and were later increased, and then simply concludes that the difference between the earlier statements and the later increase in reserves must be attributable to fraud. Courts confronting such complaints have dismissed them on the ground that they allege nothing more than "fraud by hindsight."

The Clearing House is concerned that the decision below, which permits boilerplate allegations that plaintiffs have tried and failed to obtain facts supporting their accusations of fraud to substitute for pleading fraud with particularity, will enable plaintiffs to pursue baseless claims against banks under the federal securities laws. If allowed to stand, the decision below will lead to a flood of lawsuits in the federal courts and impose enormous burdens on United States banks by forcing them to devote substantial resources to defend against frivolous claims.

The Clearing House seeks to submit this brief as *amicus curiae* in support of the Petition to stress the importance of

the issues to United States banks and to show the deleterious effects of the decision below on the nation's banking system.

Respectfully submitted,

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IN THE

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF OF THE NEW YORK CLEARING HOUSE ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

INTEREST OF *AMICUS CURIAE*

The New York Clearing House Association (the "Clearing House") is an association of eleven leading commercial banks in the City of New York.[1] The member banks of the

[1] The members of the Clearing House are The Bank of New York, The Chase Manhattan Bank, N.A., Citibank, N.A., Chemical Bank, Morgan Guaranty Trust Company of New York, Bankers Trust Company, Marine Midland Bank, N.A., United States Trust Company of New York, National Westminster Bank USA, European American Bank, and Republic National Bank of New York.

Clearing House are major sources of commercial and consumer credit in the United States, with more than $346 billion in domestic loans outstanding as of December 31, 1991. The Clearing House regularly appears as *amicus curiae* in cases raising important issues relating to banking, and its members have a common and fundamental interest in the recognition and consistent application of clear and certain rules of law to the banking industry.

The Clearing House is concerned that the standard articulated by the Third Circuit in this case will enable plaintiffs to pursue claims of fraud under the federal securities laws based on nothing more than a decline in the value of their investments in banks whose profitability is adversely affected by periodic economic downturns. Claims that a bank's disclosures *must have been* fraudulent merely because management failed to predict the future have long been rejected as insufficiently particularized and inactionable. The Third Circuit, however, would permit such claims to stand so long as they include a boilerplate recitation of plaintiffs' unsuccessful efforts to obtain any factual information that might substantiate their cries of fraud. Such a rule of law—which directly conflicts with the rules established in several other Circuits—will encourage strike suits and thereby burden the federal courts, damage defendant banks' reputations and goodwill, force banks to expend substantial resources to defend against frivolous claims, and impose additional costs and uncertainty on the United States banking system.

SUMMARY OF ARGUMENT

The opinion below addresses an extremely important issue that arises at the intersection of Fed. R. Civ. P. 9(b) ("Rule 9(b)") and Rule 10b-5 under the Securities Exchange Act of 1934 ("Rule 10b-5"): should plaintiffs bringing Rule 10b-5

claims be permitted to plead fraud--including the critical element of scienter—in wholly conclusory terms so long as they allege the nature and scope of their unsuccessful efforts to obtain specific information to support their claims? The Third Circuit's affirmative answer to this question represents an extraordinary departure from the law of other Circuits, under which a Rule 10b-5 claim will be dismissed unless it contains sufficient details concerning the "who, what, when, where, and how" of the alleged fraud.

The pleading standard announced below effectively nullifies Rule 9(b) by relieving plaintiffs of their obligation to plead fraud under the federal securities laws with particularity. Having alleged that a bank deemed its loan loss reserves adequate and its lending policies and procedures prudent, a plaintiff need only (i) plead that the bank later increased its reserves, and (ii) express a belief—lacking factual support—that any difference between the bank's disclosures and the subsequent course of events is attributable to management's fraud. The use of this kind of *res ipsa loquitur* analysis to test the sufficiency of a pleading subverts the purposes of Rule 9(b) and encourages costly and wasteful fishing expeditions to uncover support for conclusory allegations designed to coerce settlements that management agrees to only to avoid the expense and demands of litigation. The interpretation of Rule 9(b) in this case is especially inappropriate because the establishment of adequate loan loss reserves is necessarily a subjective and imprecise task best left to management's business judgment.

By effectively eliminating the requirements of Rule 9(b) in the context of securities fraud claims against banks, moreover, the decision below paves the way for a radical expansion of Rule 10b-5 into territory more appropriately left to regulation by the States. Stripped of the element of scienter, the plaintiffs' complaint in this case, like the legions

of complaints brought under Rule 10b-5 against banks in recent years, at most states a claim of mismanagement—a failure to exercise sufficient caution in making loans and to provide adequate reserves for possible losses. "Mismanagement by hindsight" is not fraud; before this case, the only recourse available to a plaintiff unable to allege facts supporting an inference that a bank's management deliberately misled investors was to bring a claim under state law.

By emasculating Rule 9(b) and allowing mismanagement claims to masquerade as securities fraud, the Third Circuit has violated fundamental principles of federalism, substantially broadened the scope of Rule 10b-5, and virtually guaranteed a flood of new lawsuits in the federal courts. Those lawsuits increase the expense and uncertainty that a prolonged recession has imposed on the United States banking system. The expense incurred in defending against frivolous fraud claims adds to the cost of credit and ultimately reduces the competitiveness of domestic banking institutions in world financial markets. This Court should grant plenary review to correct the drastic and untoward departure of the decision below from settled law.

ARGUMENT

I.

THE THIRD CIRCUIT'S INTERPRETATION OF RULE 9(b) IN THIS CASE CONFLICTS WITH OTHER CIRCUIT COURT DECISIONS THAT ESTABLISH A FAR MORE JUDICIOUS TEST OF THE SUFFICIENCY OF PLEADINGS ALLEGING THAT A BANK VIOLATED RULE 10b-5 BY INCORRECTLY ASSESSING THE ADEQUACY OF ITS LOAN LOSS RESERVES.

Plaintiffs commenced this litigation soon after UJB Financial Corp. ("UJB") announced that it would add to its loan loss reserves as a result of a substantial increase in nonperforming loans that followed on the heels of a sharp regional economic reversal. In their complaint, plaintiffs claim that UJB and its management violated Rule 10b-5 by deliberately or recklessly understating UJB's allowance for loan losses, thereby overstating income and assets, and characterizing UJB's loan loss reserves as "adequate" and its lending practices as "prudent" and "conservative." This claim is a mirror image of a multitude of "cookie-cutter" Rule 10b-5 complaints brought against banks over the past several years. (*See* the Addendum to this brief).

Despite the conclusory assertion that defendants intentionally misled the investing public by inaccurately describing UJB's loan loss reserve and lending practices in public documents, plaintiffs' complaint is devoid of any specific *factual* allegations indicating that at the time those statements were made, defendants deliberately lied about or recklessly disregarded the purported inadequacy of those lending practices or loan loss reserves. Nor do plaintiffs allege any facts about deficiencies relating to specific loans or lending procedures. Instead, plaintiffs merely quote UJB's

statements that its loan loss reserve was adequate and its lending practices prudent, note that UJB later increased its loan loss reserve, and conclude that the statements about which plaintiffs complain must therefore have been fraudulent.

Given plaintiffs' conclusory allegations and fundamentally fallacious syllogism, their complaint was an obvious candidate for dismissal under Rule 9(b), which provides that "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." The Third Circuit, however, ruled that the "relaxed" Rule 9(b) standard, which is sometimes applied where a plaintiff contends that the facts needed to allege fraud with the requisite particularity lie exclusively within a defendant's control, could be relaxed still further so that a complaint containing absolutely no factual allegations supporting an inference of fraud could nevertheless survive a motion to dismiss provided that it "delineate[s] at least the nature and scope of plaintiffs' effort to obtain, before filing the complaint, the information needed to plead with particularity." (Petitioners' Appendix I, A24).

The court below thus held that the inclusion of a boilerplate description of unsuccessful efforts to obtain facts upon which to base a claim of fraud immunizes a Rule 10b-5 complaint alleging "fraud by hindsight" that otherwise fails to satisfy the strictures of Rule 9(b). This rule of law conflicts irreconcilably with the interpretation of Rule 9(b) and Rule 10b-5 articulated by a number of other Circuits, under which claims of fraud by hindsight—which by definition fail to specify the "who, what, when, where, and how" of allegedly materially misleading statements or omissions—are deemed inactionable and insufficiently

particularized.[2] *See*, *e.g.*, *Denny* v. *Barber*, 576 F.2d 465, 470 (2d Cir. 1978); *Romani* v. *Shearson Lehman Hutton*, 929 F.2d 875, 878-80 (1st Cir. 1991); *DiLeo* v. *Ernst & Young*, 901 F.2d 624, 627-28 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990); *Sinay* v. *Lamson & Sessions Co.*, 948 F.2d 1037 (6th Cir. 1991); *Ciresi* v. *Citicorp*, 782 F. Supp. 819, 822 (S.D.N.Y. 1991), *aff'd without opinion*, 956 F.2d 1161 (2d Cir. 1992).[3] Indeed, as explained more fully in Point I(B) of UJB's Petition, the decision below even conflicts with the Third Circuit's own decisions in *Decker* v. *Landmark Sav. Ass'n*, No. 91-3776 (3d Cir. May 20, 1992), which was decided on the same day as *Shapiro*, and *Christidis* v. *First Pa. Mortgage Trust*, 717 F.2d 96 (3d Cir. 1983).

The reasoning of the cases that conflict with the decision below is compelling. As the Seventh Circuit put it in *DiLeo*, 901 F.2d at 627,

> [t]he story in this complaint is familiar in securities litigation. At one time the firm bathes itself in a favorable light. Later the firm discloses that things are less rosy. The plaintiff contends that the difference must be attributable to fraud. "Must be" is the critical phrase, for the complaint offers no information

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[2] Claims of fraud by hindsight under Rule 10b-5 are subject to dismissal for failure to state a claim as well as for failure to allege fraud with particularity. No matter which procedural approach is taken, the underlying analysis is essentially the same: allegations that disclosures eventually turned out to be incorrect, when unaccompanied by any factual details indicating that the disclosures were intentionally or recklessly misleading when made, are deficient because they do not plead fraud, much less plead it with particularity.

[3] As noted in UJB's Petition at page 11 n.4, many district court decisions have followed the reasoning of these cases.

> other than the differences between the two statements of the firm's condition. Because only a fraction of financial deteriorations reflects fraud, plaintiffs may not proffer the different financial statements and rest. Investors must point to some facts suggesting that the difference is attributable to fraud.

See also Denny, 576 F.2d at 470 (declining to subject defendant bank to potential liability under Rule 10b-5 merely because its management did not exercise "greater clairvoyance"); *Romani*, 929 F.2d at 880 (noting that if claims of fraud by hindsight were "deemed sufficient, the advent of a recession could be expected to trigger a multitude of complaints in which plaintiffs seek to impose liability for their financial disappointments based on entirely fabricated scenarios of fraud").

The use of Rule 9(b) to condemn claims of fraud by hindsight fulfills the purposes Rule 9(b) was designed to serve, including (i) protecting defendants from the damage to their reputations resulting from unsubstantiated claims of fraud, (ii) limiting the burden and expense associated with the defense and adjudication of such claims, (iii) curtailing the commencement of lawsuits as a device to engage in fishing expeditions, and (iv) precluding the filing of strike suits. *See*, *e.g.*, *Romani*, 929 F.2d at 878; *Cosmas* v. *Hassett*, 886 F.2d 8, 11 (2d Cir. 1989); *New England Data Servs., Inc.* v. *Becher*, 829 F.2d 286, 289 (1st Cir. 1987); *Semegen* v. *Weidner*, 780 F.2d 727, 731 (9th Cir. 1985). The risk of strike suits, and therefore the need for a strict interpretation of Rule 9(b), is enhanced in cases such as this that involve high stakes and potentially extensive and expensive discovery. *See*, *e.g.*, *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 741 (1975) (recognizing that liberal discovery rules represent "a social cost rather than a benefit" insofar as they

permit plaintiffs "to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the process will reveal relevant evidence.").

The firm application of Rule 9(b) is especially appropriate in the context of claims that a bank violated Rule 10b-5 by incorrectly assessing the adequacy of its loan loss reserve. A loan loss reserve is an "account established based on a bank's loss experience to compensate for expected losses from the loans extended." American Bankers Association, *Banking Terminology* 154 (1981). Banks set their reserves, which are funded through quarterly changes against earnings, by estimating the total potential loss of principal inherent in their particular loan portfolios. *See generally* Francis X. Conway & William A. Siegenthaler, *Loan Loss Reserves: Tax, Regulatory and Adequacy Issues*, 70 J. of Comm. Bank Lending 1, 9-14 (Sept. 1987).

Determining the appropriate level of a loan loss reserve is more an art than a science, requiring an inherently subjective exercise of managerial judgment based on consideration of a broad range of factors. *See* OCC Banking Circular No. 201 (Feb. 20, 1992), *reprinted in* [Current] Fed. Banking L. Rep. (CCH) ¶ 51,132, at 30,133-6; Office of the Comptroller of the Currency, *Comptroller's Handbook for National Bank Examiners* § 217.1, at 2-3 (1984) (providing non-exhaustive list of factors taken into account in establishing loan loss reserves). As the SEC has stated, "[a]rriving at an appropriate reported allowance for loan losses necessarily involves a high degree of management judgment." SEC Financial Reporting Release No. 28, *Accounting for Loan Losses by Registrants Engaged in Lending Activities* (Dec. 1, 1986), *reprinted in* 6 Fed. Sec. L. Rep. (CCH) ¶ 73,126D, at 62,760. Indeed, one commentator

has noted that "at best, the estimation of future loan and lease losses inherent in a present loan portfolio held by a bank is largely judgmental; at worst it is completely arbitrary. . . . It is a judgment call and, thus, subjective . . . ." Hector R. Anton, *Managing the Allowance for Loan and Lease Losses* 11, 15 (1988).

A loan loss reserve, moreover, represents an estimate of losses made at a specific time. Subsequent significant changes in the economic environment, whether for better or worse, will almost always require a reevaluation of that estimate. As recent events have demonstrated, a sharp regional economic downturn will lead to increases in loan loss reserves, and corresponding decreases in earnings and stock prices, at virtually every bank in the region. Changes in the size of a bank's loan loss reserve do not mean that a bank's original assessment was incorrect, much less fraudulent, when made.[4]

Because determinations of the appropriate level of loan loss reserves are by nature subjective and imprecise, there simply is no way to guarantee that a bank's reserves will ultimately cover actual losses. Accordingly, courts must view with caution claims that the difference between the reserve that a bank deems adequate at a given time and the reserve the bank finds appropriate at a later time demonstrates that the bank's management perpetrated a fraud on the investing public. Only by requiring plaintiffs to plead with particularity that a defendant bank and its management intended to and did

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[4] Indeed, given that FASB Statement No. 5 of Financial Accounting Standards limits loan loss reserves to losses that are both probable and reasonably estimable, banks cannot maintain large reserves merely because a future recession might lead to an increase in the volume of nonperforming loans. *See* Financial Accounting Standards Board, *Accounting Standards, Current Text—General Standards, Contingencies* § C59.105 (1991).

defraud investors will there be some assurance that a bank's establishment of loan loss reserves and other lending practices are properly the subject of an action under the anti-fraud provisions of the federal securities laws.[5]

II.

THE DECISION BELOW CONFLICTS WITH DECISIONS OF THIS COURT AND OPENS THE DOOR TO THE FEDERALIZATION OF AREAS OF CORPORATE LAW THAT HAVE TRADITIONALLY BEEN THE PROVINCE OF THE STATES.

In *Santa Fe Indus., Inc.* v. *Green*, 430 U.S. 462, 474-80 (1977), this Court definitively ruled that allegations of corporate mismanagement do not state a claim under Rule 10b-5. As the Court pointed out, to extend the federal securities laws to claims of corporate mismanagement would not only pose a "danger of vexatious litigation which could result from a widely expanded class of plaintiffs," but would also "quite possibly interfere with state corporate law," which establishes the framework of carefully crafted fiduciary duties that both protects investors and enables management to exercise its business judgment. *Id.* at 479 (quotation omitted). Moreover, the federalization of mismanagement claims "would discourage firms from taking risk," which in turn

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[5] Plaintiffs can satisfy the requirements of Rule 9(b) in these sorts of cases: motions to dismiss Rule 10b-5 claims against banks have been denied where the complaints describe deficiencies relating to specific loans and lending procedures, or allege material misstatements of fact not related to loan loss reserves, and set forth circumstances from which scienter may be inferred. *See Nicholas* v. *Poughkeepsie Sav. Bank/FSB*, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,606, at 97,840-41 (S.D.N.Y. 1990); *Hurley* v. *FDIC*, 719 F. Supp. 27, 29-31 (D. Mass. 1989).

would "make investors as a whole worse off." *DiLeo*, 901 F.2d at 627. In the case of banks, such an approach would also discourage the extension of credit.

By "relaxing" the standard of Rule 9(b) to an unprecedented extent, the decision below conflicts with *Santa Fe* by drastically enlarging the scope of permissible claims under Rule 10b-5. Plaintiffs allege no facts suggesting that when UJB's management described its loan loss reserves as adequate and its lending practices as prudent, it believed that those descriptions were inaccurate. Nor do plaintiffs plead facts indicating that UJB's management departed from any appropriate standard for setting loan loss reserves, much less that it recklessly disregarded information that would have led it to increase UJB's reserve at any time before that reserve was actually increased. Thus, when stripped of purely conclusory allegations of fraud and reduced to its essence, plaintiffs' claim is at most a claim that UJB mismanaged its commercial loan portfolio and loan loss reserves.[6] Although the court below pays lip service to the rule of *Santa Fe*

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[6] The reliance in the decision below upon *Virginia Bankshares, Inc.* v. *Sandberg*, 111 S. Ct. 2749 (1991), was misplaced. (*See* A18-20). In *Virginia Bankshares*, a jury found that defendants' description of a tender offer price as "high" and the terms of a merger as "fair" was false and misleading. The Court held that defendants' statements were actionable under Rule 14a-9 because although they were expressions of belief, they were not only material but were also types of beliefs that could be readily supported or contradicted by facts, as they were during the trial of the case. *Id.* at 2758-59. *Virginia Bankshares* did not interpret or apply Rule 9(b) or address the sufficiency of any pleading. Nor can it be read to support the view that a complaint alleging that statements of belief were false when made could withstand scrutiny under Rule 9(b) where, as here, the challenged statements of belief are by nature highly subjective rather than objectively verifiable, and the complaint pleads no facts demonstrating or even suggesting that the statements were false.

(A20-21), it violates the letter and spirit of that decision by interpreting Rule 9(b) to allow plaintiffs to proceed with such a claim under Rule 10b-5.

The determination of the appropriate level of a bank's loan loss reserve is a prototypical example of the exercise of management's business judgment. Management must use its expertise and exercise discretion in such areas free of the fear that its decisions will be subject to second-guessing by disappointed investors and the courts. To protect good faith decisionmaking by management, the States have formulated the business judgment rule, which requires that a claim of mismanagement must be supported by facts demonstrating that managers had a conflict of interest or violated a duty of care owed to the corporation.[7] Federal courts have long recognized that the regulation of such matters of corporate governance is the province of the States. *See, e.g., Kamen* v. *Kemper Fin. Servs., Inc.*, 111 S. Ct. 1711, 1717, 1720-21 (1991); *CTS Corp.* v. *Dynamics Corp.*, 481 U.S. 69, 89 (1987).

The decision below permits claims of fraud under federal law based on allegations that fail to meet the traditional pleading standards for a claim of mismanagement under state law. Nothing in Rule 9(b) or Rule 10b-5 justifies this intrusion on traditional state regulation of domestic corporations, especially in circumstances where the challenged business decision is necessarily imprecise and subject to second-guessing with the benefit of 20-20 hindsight.

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[7] *See, e.g., Unocal Corp.* v. *Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985); *Auerbach* v. *Bennett*, 393 N.E.2d 994, 1000 (N.Y. 1979).

CONCLUSION

Lawsuits raising substantially similar claims concerning purported misrepresentations of the adequacy of banks' loan loss reserves have deluged the federal courts and the banking industry over the last several years. The sheer number of these cases and the similarity of their allegations, along with the speed with which they were brought, demonstrates that plaintiffs have not separated actual fraud from either the effects of a recession or occasions of mismanagement before bringing suit. Managers and directors of banks, already faced with daunting economic problems, should not have their honest business judgments challenged based on conclusory allegations of fraud. Plaintiffs must be required to allege specific facts substantiating accusations of fraud at the outset of litigation. The decision below would eliminate that requirement.

For the reasons stated herein and in the Petition, certiorari should be granted to review the judgment of the United States Court of Appeals for the Third Circuit and resolve the conflict with the rule of law established by other Circuits.

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September 11, 1992

ADDENDUM OF LOAN LOSS RESERVE CASES

Research has revealed 48 other cases involving claims that a bank violated Rule 10b-5 by mischaracterizing its loan loss reserves and lending practices, and there are surely many more that have not been the subject of reported decisions. The 48 cases are:

Decker v. *Landmark Sav. Ass'n*, No. 91-3776 (3d Cir. May 20, 1992)

DiLeo v. *Ernst & Young*, 901 F.2d 624 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990)

Christidis v. *First Pa. Mortgage Trust*, 717 F.2d 96 (3d Cir. 1983)

Bogart v. *National Community Banks, Inc.*, 1992 WL 203788 (D.N.J. Apr. 25, 1992)

Harris v. *First Chicago Corp.*, 789 F. Supp. 919 (N.D. Ill. 1992)

Ferber v. *Travelers Corp.*, 785 F. Supp. 1101 (D. Conn. 1992)

In re Atlantic Fin. Fed. Sec. Litig., 1992 WL 50072 (E.D. Pa. Feb. 28, 1992)

Feinberg v. *Hibernia Corp.*, 1992 WL 54738 (E.D. La. Mar. 9, 1992)

Ciresi v. *Citicorp*, 782 F. Supp. 819 (S.D.N.Y. 1991), *aff'd*, 956 F.2d 1161 (2d Cir. 1992)

Fox v. *Equimark Corp.*, 782 F. Supp. 295 (W.D. Pa. 1991)

Vachon v. *Baybanks, Inc.*, 780 F. Supp. 79 (D. Mass. 1991)

Urbach v. *Sayles*, 779 F. Supp. 351 (D.N.J. 1991)

Hershey v. *MNC Fin., Inc.*, 774 F. Supp. 367 (D. Md. 1991)

In re Meridian Sec. Litig., 772 F. Supp. 223 (E.D. Pa. 1991)

Hershfang v. *Citicorp*, 767 F. Supp. 1251 (S.D.N.Y. 1991)

Wilkes v. *Heritage Bancorp, Inc.*, 767 F. Supp. 1166 (D. Mass. 1991)

Cagan v. *Anchor Sav. Bank FSB*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 95,324 (E.D.N.Y. 1990)

Salit v. *Centerbank*, 767 F. Supp. 429 (D. Conn. 1990)

Steiner v. *Shawmut Nat'l Corp.*, 766 F. Supp. 1236 (D. Conn. 1991)

Shields v. *Amoskeag Bank Shares, Inc.*, 766 F. Supp. 32 (D.N.H. 1991)

Dubowski v. *Dominion Bankshares Corp.*, 763 F. Supp. 169 (W.D. Va. 1991)

Save On Surplus Pension Plan v. *United Saver's Bancorp, Inc.*, 760 F. Supp. 971 (D.N.H. 1990)

In re Midlantic Corp. Shareholder Litig., 758 F. Supp. 226 (D.N.J. 1990)

Driscoll v. *Landmark Bank for Sav.*, 758 F. Supp. 48 (D. Mass. 1991)

Amerifirst Bank v. *Bomar*, 757 F. Supp. 1365 (S.D. Fla. 1991)

Gollomp v. *MNC Fin., Inc.*, 756 F. Supp. 228 (D. Md. 1991)

Boyle v. *Merrimack Bancorp, Inc.*, 756 F. Supp. 55 (D. Mass. 1991)

Cooperman v. *One Bancorp*, 135 F.R.D. 9 (D. Me. 1991)

Haft v. *Eastland Fin. Corp.*, 755 F. Supp. 1123 (D.R.I. 1991)

Mermelstein v. *Bank of New York*, No. 90 CV 3400 (EHN) (E.D.N.Y. June 14, 1991)

In re First Constitution Shareholders Litig., 1991 WL 218083 (D. Conn. Sept. 13, 1991)

Zimmerman v. *Shawmut Nat'l Corp.*, 1991 WL 274342 (D. Conn. Dec. 13, 1991)

Sonnenberg v. *Prospect Park Fin. Corp.*, 1991 WL 329755 (D.N.J. Aug. 20, 1991)

Cole v. *Federal Home Loan Mortgage Corp.*, 1991 WL 180295 (D.C.D.C. Aug. 27, 1991)

In re Chase Manhattan Corp. Sec. Litig., 1991 WL 152618 (S.D.N.Y. Aug. 1, 1991)

In re VMS Sec. Litig., 752 F. Supp. 1373 (N.D. Ill. 1990)

Ackerman v. *Bankworcester Corp.*, 751 F. Supp. 11 (D. Mass. 1990)

Krim v. *BancTexas Group, Inc.*, Civ. Action No. CA3-89-0369-D (N.D. Tex. Apr. 24, 1990)

Feigenbaum v. *Bankeast Corp.*, Civ. Action No. 90049L (D.N.J. 1990)

Balsam v. *Eastchester Fin. Corp.*, CV 90-2947 (E.D.N.Y. 1990)

Zucker v. *MNC Fin., Inc.*, Civ. Action No. 90-1319 (D. Md. 1990)

Hall v. *Southeast Banking Corp.*, Civ. Action No. 90-00838 (S.D. Fla. 1990)

First Am. Bank & Trust v. *Frogel*, 726 F. Supp. 1292 (S.D. Fla. 1989)

Zinberg v. *Washington Bancorp, Inc.*, 1989 WL 300323 (D.N.J. June 20, 1989)

In re First Fidelity Bancorporation Sec. Litig., [1990] Fed. Sec. L. Rep. (CCH) ¶ 95,299 (D.N.J. 1989)

Abrahamson v. *Western Sav. & Loan Ass'n*, 1989 WL 259997 (D. Ariz. July 7, 1989)

Rembold v. *Pacific First Fed. Sav. Bank*, 1988 U.S. Dist. LEXIS 6297 (D. Ore. June 17, 1988)

Naye v. *Boyd*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,979 (W.D. Wash.), *aff'd*, 804 F.2d 146 (9th Cir. 1986)

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No. 92-267

In The

Supreme Court of the United States

October Term, 1992

UJB FINANCIAL CORP., et al.,

Petitioners,

v.

IRWIN SHAPIRO, ROBERT BASSMAN, JEROME KATZ, NORMAN SALTSITZ, JEAN LEE, and CHAPPAQUA FAMILY TRUST,

Respondents.

Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Third Circuit

RESPONDENTS' JOINT RESPONSE TO THE MOTIONS OF THE NEW YORK CLEARING HOUSE ASSOCIATION AND THE AMERICAN BANKERS ASSOCIATION FOR LEAVE TO FILE A BRIEF *AMICUS CURIAE*

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September 18, 1992

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Respondents Irwin Shapiro, Robert Bassman, Jerome Katz, Norman Saltsitz, Jean Lee, and Chappaqua Family Trust (collectively, "Respondents") respond to the motions of the New York Clearing House Association and the American Bankers Association (collectively, "Movants") to file briefs *amicus curiae* in support of the Petitoners. The motions, like the previous motion filed by other purported *amici*, disregard the rules of this Court, do not aid this Court's consideration of the issue before it, and should be denied.

As Respondents pointed out in response to a previous motion for leave to file a brief *amicus curiae*, this Court's rules governing the filing of briefs *amicus curiae* at the petition stage explicitly warn potential *amici* against filing motions for leave to file a brief where consent has been withheld, and against filing proposed briefs with redundant arguments. *See* Sup. Ct. Rule 37. Respondents have not consented to the filing of the proposed briefs because respondents did not believe that briefs from the Movants would aid in resolution of the petition. Movants' proposed briefs, in fact, do not bring to the Court any matter, relevant or otherwise, that has not previously been brought to the Court's attention. The proposed briefs serve no purpose beyond adding to the burden of the Court's staff and facilities.

Movants' proposed briefs, moreover, do not aid in this Court's consideration of the limited question presently before it. The bulk of Movants' proposed briefs are devoted to addressing questions that go to the merits of the decision below, as opposed to reasons why this Court should, or should not, issue a writ of *certiorari*. The New York Clearing House Association, for example, claims

that its filing is justified to "stress the importance of the issues to United States banks and to show the deleterious effects of the decision below on the nation's banking system." However, the New York Clearing House Association's proposed brief does nothing of the sort. To the contrary, it merely reiterates arguments already in front of the Court.

Similarly, the American Bankers Association claims that its filing is designed to emphasize the supposed importance of the issues to the banking industry. However, the American Bankers Association's brief offers nothing more than a discussion of the mechanics for setting loan loss reserves, which, in light of the discussion in the opinion below of the same mechanics and the actionability of loan loss reserves *per se* under the federal securities laws, is entirely gratuitous.

Neither purported *amicus* concerns itself with the actual decision below. Both base their arguments on a distortion of the decision below (similar to Petitioners' distortion). The actual decision below, in fact, does not justify Movants' claimed concerns. *See* Jay B. Casner, Rita W. Gordon, *Shareholder Suits: Ruling a Victory for Banks*, American Banker, August 5, 1992, at 4.

The proposed briefs, therefore, add nothing to this Court's consideration of the issues presently before it. As

a result, the motions for leave to file briefs *amicus curiae* should be denied.

DATED: September 18, 1992

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No. 92-267

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IN THE

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October Term, 1992

UJB FINANCIAL CORP., et al.,

Petitioners,

against

IRWIN SHAPIRO, ROBERT BASSMAN, JEROME KATZ, NORMAN SALSITZ, JEAN LEE, and CHAPPAQUA FAMILY TRUST,

Respondents.

Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Third Circuit

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REPLY BRIEF FOR PETITIONERS[1]

Respondents contend that this is a run of the mill case, totally lacking in any public interest, and involving the application of a common interpretation of a Federal Rule of Civil Procedure to facts alleged in a particular complaint. That is exactly what this case is not. The three *amici curiae* briefs—filed by the American Bankers Association ("ABA"), the Securities Industry Association ("SIA") and the New York Clearing House Association ("NYCHA")—in support of the petition for a writ of certiorari highlight the significance of the legal and policy issues raised by the Third Circuit's decision to the country's two key financial sectors. According to the ABA, "[t]he matter decided by the Court of Appeals involves a legal issue of the utmost concern to the banking industry." (ABA Br. at 2). The SIA has stated that "[i]t is essential that the Court prevent the development of a rule exposing banks, other issuers, and securities underwriters, to costly litigation every time their business or, in the case of underwriters, the business of an issuer whose securities they have underwritten declines" (SIA Br. at 21). As demonstrated by Petitioners' opening brief, as well as the *amici* briefs, this petition addresses the promulgation by the Third Circuit of a new, relaxed pleading standard under Rule 9(b), Fed. R. Civ. P., that conflicts with the pleading standards of other circuits, relaxes the Third Circuit's own prior standard, and ignores the express terms and frustrates the purposes of Rule 9(b).

The Third Circuit, in reversing the order of the district court dismissing this action, announced a new pleading standard effectively eviscerating Rule 9(b). The *UJB* decision "provide[s] plaintiffs with a blueprint on how to plead this kind of cause of action and accuse bank officials of fraud in the absence of facts upon which to allege specific acts of fraud with particularity." Brodsky, *Suits Resulting From The Banking Crisis*, N.Y.L.J., July 30, 1992.

The Third Circuit's new pleading standard permits a

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1. Petitioners incorporate by reference the Rule 29.1 Statement on page ii of the Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Third Circuit (hereinafter, "Pet.").

plaintiff to support a fraud claim by alleging the efforts undertaken to uncover the facts supporting the fraud even if no facts were discovered by those efforts. Pleading the absence of facts to support a claim of fraud cannot substitute for Rule 9(b)'s required pleading of such facts, no matter how diligent the search for such facts was. A plaintiff's inability to find supporting facts after diligent inquiry ought to provide grounds to end the litigation, not an excuse to continue it.

Equally meritless is Respondents' contention that since they were provided the opportunity to replead consistent with the new standard, the Third Circuit's decision is not ripe for certiorari. This Court unquestionably has authority to grant a writ of certiorari, regardless of the status of the litigation; and it has not hesitated to grant petitions with respect to decisions that have reversed dismissals or otherwise remanded for further proceedings. Indeed, the pleading standard announced by the Third Circuit can only be challenged by a defendant in the procedural posture of Petitioners here (*see infra* pp 3-4).

With respect to materiality, Respondents barely mention the Third Circuit's language challenged by Petitioners under *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), and instead contend that the court's discussion of materiality is consistent with this Court's decision in *Virginia Bankshares, Inc. v. Sandberg*, 111 S. Ct. 2749 (1991). Petitioners do not contest here the Third Circuit's application of *Virginia Bankshares*, but rather argue that the Third Circuit's statement that by commenting on a matter, a person makes such matter material is utterly irreconcilable with the flatly contrary holding of this Court in *Basic*. On this point, *Virginia Bankshares* did not even address, much less overrule *Basic*.

I. THE ISSUES RAISED BY THIS PETITION ARE RIPE FOR CONSIDERATION BY THIS COURT

Respondent Shapiro's argument that this Court should not review the Third Circuit's decision because it remanded with instructions that Respondents be given another opportunity to replead is meritless. Its adoption would insure that the Third Circuit's relaxed pleading standard

could not be challenged.[2]

This Court's authority to grant the writ here has been established for a century. In *Forsyth v. City of Hammond*, 166 U.S. 506, 513 (1897), this Court declared unequivocally that it has "unlimited power" to grant certiorari, and such power is "not affected by the condition of the case as it exists in the court of appeals. [This power] may be exercised before or after any decision by that court, and irrespective of any ruling or determination therein." This Court repeatedly has granted certiorari where a courts of appeals had remanded for further proceedings.[3]

Respondents' argument that this Court should not consider the petition in effect is an attempt to superimpose onto this Court the limitations on the jurisdiction of the Court of Appeals to hear appeals only of final orders. There is no such limitation on this Court's powers.

Further, the instant petition provides the only procedural context in which a defendant could ever challenge the Third Circuit's Rule 9(b) pleading standard. Denial of a motion to dismiss (e.g., on remand) is a non-final order which is not appealable. *See, e.g., Goetz v. Cappelen*, 946

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2. Contrary to Respondent Shapiro's assertion (at 7), the right to replead is *not* uniformly granted by Courts of Appeals where, as here, a plaintiff was afforded the opportunity to replead by the district court but expressly *declined* such opportunity in an effort to confer jurisdiction upon the Court of Appeals. A plaintiff's express waiver of the right to replead irrevocably waives such option and that plaintiff "must stand or fall" on the complaint on appeal. *See DiVittorio v. Equidyne Extractive Indus., Inc.*, 822 F.2d 1242, 1247 (2d Cir. 1987).

3. *See, e.g., School Bd. of Nassau County, Fla. v. Arline*, 480 U.S. 273 (1987) (petition granted where court of appeals reversed dismissal and remanded for further proceedings); *St. Paul Fire & Marine Ins. Co. v. Barry*, 438 U.S. 531 (1978) (petition granted where court of appeals reversed dismissal on the pleadings); *Weatherford v. Bursey*, 429 U.S. 545 (1977) (petition granted where court of appeals remanded for presentation of a qualified immunity defense); *see also* Wright, Miller & Cooper, *Federal Practice and Procedure*: Jurisdiction 2d § 4036, at 30 n.57 (1988) (citing more than twenty cases of certiorari to review non-final dispositions of appellate courts).

F.2d 511, 514 (7th Cir. 1991). If the case were remanded and the repled complaint survived challenge under the Third Circuits's new standard but defendants won at trial or on summary judgment, there would be no justiciable appeal from the initial denial of the Rule 9(b) motion based on that improper standard. If plaintiffs prevailed at trial, their pleadings would have been deemed to conform to the proof (*see* Rule 15, Fed. R. Civ. P.) and there would be no basis for defendants to obtain a reversal on the ground that the complaint should have been dismissed under Rule 9(b) in the first place. In short, Petitioners (and every other defendant in such a case) will be prevented from ever challenging the appropriateness of any application of the new, relaxed standard should this Court decide not to grant this petition now.[4]

II. THE THIRD CIRCUIT ESTABLISHED A NEW PLEADING STANDARD INCONSISTENT WITH RULE 9(b) AND THE STANDARD OF OTHER CIRCUITS

At issue here is a new pleading standard under Rule 9(b) promulgated for the first time by the Third Circuit in the decision below. Respondents argue that (1) no new standard was adopted by the Third Circuit and this is really a fact-specific decision; and (2) the Third Circuit's standard is consistent with the standards of other circuits. As demonstrated in Petitioners' initial brief, and as highlighted by the filing of *amici curiae* briefs in support of the petition, the Third Circuit's decision has far-reaching implications and involves much more than a fact-specific evaluation of a particular complaint. Further, Respondents' contention that the Third Circuit's standard is the same as in other circuits is

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4. Such a result is contrary to this Court's review under the analogous "capable of repetition, but evading review" exception to issues of mootness. *See, e.g., Weinstein v. Bradford*, 423 U.S. 147, 148-49 (1975) (court will review a mooted issue where "challenged action was in its duration too short to be fully litigated prior to its cessation or expiration and [ ] there was a reasonable expectation that the same complaining party would be subjected to the same action again").

plainly incorrect.

A. The Third Circuit's Decision Does Not Turn On The Facts Alleged In This Specific Complaint

Respondents' argument that this petition involves a fact specific issue that this Court should refuse to consider is unavailing. The petition here addresses the new legal standard enunciated by the Third Circuit and the flat-out inconsistency of that standard with the language and purpose of Rule 9(b), as recognized by other circuits. The application of this new standard to any particular complaint may very well be fact-specific, but the standard under which a complaint is to be evaluated is clearly a legal issue.[5]

Rule 9(b) requires that "all averments of fraud . . . shall be stated with particularity," and all circuit and district courts should apply a *common* standard under that Rule against which to measure the specific allegations in each individual complaint. Failure of this Court to declare the proper, uniform standard will invite blatant forum-shopping in securities litigation.

There is simply no way to reconcile the standard applied by the Third Circuit with the standard applied by the Seventh and other circuits to complaints containing similar factual allegations. In *DiLeo v. Ernst & Young*, 901 F.2d 624 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990), the Seventh Circuit rejected plaintiffs' fraud pleading (which, like the instant complaint, contained no *facts*, only conclusory characterizations of the supposed wrongdoing), noting:

> At one time the firm bathes itself in a favorable light. Later the firm discloses that things are less rosy. The plaintiff contends that the difference must be

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5. Respondents' reliance upon the pre-*UJB* decision in *Urbach v. Sayles*, 779 F. Supp. 351 (D.N.J. 1991), as illustrative of the fact specific nature of any Rule 9(b) analysis is misplaced. In *Urbach*, the court expressly stated that "the 9(b) pleading standard adopted in *Christidis* and *Fox* is identical to the showing required with this opinion." *Id.* at 363.

> attributable to fraud. . . . [T]he complaint offers no information other than the differences between the two statements of the firm's condition. . . . [P]laintiffs may not proffer the different financial statements and rest. Investors must point to some facts suggesting that the difference is attributable to fraud. 901 F.2d at 627.

Moreover, the confusion among the district courts referenced by Petitioners does not arise, as Respondents contend, from factual differences in the complaints, but rather from the differing standards applied by the district courts to virtually identical "boilerplate" pleadings by the same group of plaintiffs' counsel (Pet. 18-19).[6] *See also* Pet. at 10.

The pleading standard set forth by the Third Circuit is also contrary to one of the fundamental purposes of Rule 9(b), to "inhibit the filing of a complaint as a pretext for discovery of unknown wrongs." *Goldman v. Belden*, 98 F.R.D. 733, 735-36 (W.D.N.Y. 1983). Such an "approach does violence to the salient purposes of the Rule, which is designed to discourage this 'sue first, ask questions later' philosophy." *McFarland v. Memorex Corp.*, 493 F. Supp. 631, 639 (N.D. Cal. 1980) (citation omitted). Under the Third Circuit's standard however, a plaintiff may plead how hard but unsuccessfully it searched for facts to support its suppositions and then be free to pursue and prosecute such claim anyway, in the hope of finding some facts, after lengthy and costly discovery, which could justify the fraud

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6. The Complaint here is virtually identical to the complaints in the "flood of securities fraud class action suits" filed throughout the Northeast and other regions of the country containing "allegations . . . so general that they could be filed against any financial institution." *Shields v. Amoskeag Bankshares, Inc.*, 766 F. Supp. 32, 38 (D.N.H. 1991). Despite the similarity of these complaints, some courts have dismissed the claims, while others have not. *See* Pet. at 18-19. This Court should grant a writ of certiorari "to formulate the necessary guidelines in the area." *Schlagenhauf v. Holder*, 379 U.S. 104, 112 (1964).

charges levelled against defendants, or more likely, as this Court has recognized, to use the pendency of such litigation and its potential (however slight) for astronomical class-wide damages, to coerce a settlement.[7]

B. Respondents Ignore The New Relaxed Standard Adopted By The Third Circuit

Contrary to the impression Respondents try to create, the Third Circuit here did adopt a new, relaxed pleading standard which conflicts with the standard of other circuits. Third Circuit decisions subsequent to *Christidis* but even before *UJB* already had commenced the process of relaxation of the Rule in a manner different than other Circuits. *See, e.g., McMahon v. Hibbard Brown & Co.*, No. 91-6568, 1992 U.S. Dist. LEXIS 3957 at *6 (E.D. Pa. Apr. 1, 1992) ("[t]he Third Circuit Court of Appeals and the district courts within the Third Circuit have taken a more liberal view of Rule 9(b) than courts in the Southern District of New York and Northern District of Illinois"); *Gopez v. Shin*, 736 F. Supp. 51, 54-55 (D. Del. 1990) (Third Circuit "has taken a different view of the demands of Rule 9(b) for claims of fraud under the federal securities laws[,] . . . expressly reject[ing] the . . . request . . . for the court to adopt a position similar to that of the Second Circuit"). The Third Circuit's decision in *UJB* further widened the existing gap. Under the Third Circuit's new standard, all that is necessary is a boilerplate allegation that the supposed facts are in defendants' control and detailing the unsuccessful efforts made by plaintiffs to uncover facts to support the fraud allegation. In *Lerch v. Citizens First Bancorp. Inc.*, No. 90-3538 (D.N.J. Aug. 12, 1992) (App. 1) the court, relying on *UJB*, held plaintiff need only allege "1) how plaintiffs attempted to gain the necessary information to plead fraud more particularly; and 2) that the defendants have exclusive control over necessary

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7. *See, e.g., Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 741 (1975) (recognizing the potential for "a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value").

information." Slip op. at 21 (A-16).

The stark difference between the standard applied by the First, Second and Seventh Circuits and the new pleading standard announced by the Third Circuit is that under the *UJB* standard, a plaintiff having *no* facts to show how any defendant engaged in any wrongdoing nonetheless can point to the change in financial condition from one set of periodic public filings to another, add a boilerplate allegation describing the efforts made to uncover additional information, and thereby satisfy Rule 9(b). This standard, which permits "fraud-by-hindsight" allegations, has been rejected time and time again by courts in the First, Second and Seventh Circuits. *See, e.g., Romani v. Shearson Lehman Hutton*, 929 F.2d 875 (1st Cir. 1991); *DiLeo*, 901 F.2d 624; *Denny v. Barber*, 576 F.2d 465 (2d Cir. 1978); Pet. at 11-14.

Under this new standard, any plaintiff will be able to satisfy the pleading requirements of Rule 9(b) as long as a diligent—albeit totally unsuccessful—investigation is pled. This cannot and should not be enough to satisfy Rule 9(b), which requires the plaintiff to plead facts, not the absence of facts. The failure to uncover facts indicating that a fraud has occurred is certainly as likely, if not more likely, to suggest the *absence* of a fraud than to support an inference of fraud. The Third Circuit's approach thus is inconsistent with the language of and important policy concerns underlying Rule 9(b), all as recognized by other circuits. Absent review of the *UJB* decision by this Court at the present time, district courts within the Third Circuit will continue to allow plaintiffs with unsubstantiated claims of fraud to congest the courts and needlessly occupy the time and resources of countless corporate and individual defendants in an effort to support a fraud claim that has no basis other than the speculation of plaintiff's counsel.

Respondents' argument that there is no intra-circuit conflict in the Third Circuit is similarly untrue. While the Third Circuit paid lip service to its earlier decision in *Christidis v. First Penn. Mort. Trust*, 717 F.2d 96 (3d Cir. 1983), the court plainly did not follow that decision. As recognized by the district court below (A-49), *Christidis* required a plaintiff to allege *how* the statements were

fraudulent (e.g., how defendants departed from proper standards for setting loan loss reserves). The Third Circuit's decision in *UJB* nowhere discusses, much less adheres to, this requirement. Yet another panel's order, *Decker v. Landmark Sav. Ass'n*, No. 91-3776, 1992 U.S. App. LEXIS 13832 (3d Cir. May 20, 1992), affirmed a decision to dismiss an almost identical complaint based upon the *Christidis* standard. Thus, the intra-circuit conflict is clear.

The current litigation explosion is too well known to require comment. The enormous costs to the courts and the parties—and to entire segments of the financial services industries, as emphasized by the *amici* here—associated with complex securities litigation of this type are equally notorious. It therefore is untenable that this Court could let stand a decision which excuses plaintiffs from compliance with the pleading requirements of Rule 9(b). The cost and delay problems currently plaguing our judicial system already stem, in part, from judicial decisions that have dramatically reduced plaintiffs' burden of establishing their case by, for example, excusing plaintiffs from demonstrating actual knowledge of or reliance on a particular misleading statement or omission (*Basic*, 485 U.S. 224 (endorsing the fraud on the market theory)) or excusing plaintiffs from demonstrating a causal link between alleged misrepresentations and damages, i.e., loss causation (*In Re Washington Pub. Power Supply Sys. Sec. Litig.*, 650 F. Supp. 1346, 1353-54 (W.D. Wash. 1986) (plaintiff may recover damages where misrepresentation is material to the price paid for the security, even if a supervening event unrelated to the fraud is responsible for damages)). To now excuse plaintiffs from the requirements of Rule 9(b) as well would simply open the floodgates the rest of the way, burdening the courts and issuers even further with actions worth nothing more than their incremental settlement value. *See*, *supra* n. 7.

III. THIRD CIRCUIT'S RULING ON MATERIALITY IS IN DIRECT CONTRADICTION OF THIS COURT'S DECISION IN BASIC

Petitioners demonstrated that the Third Circuit's statement in *UJB* that "[b]y addressing the quality of a

particular management practice, a defendant declares the subject of its representation to be material to the reasonable shareholder," *UJB*, 964 F.2d at 282 (A-18) flatly contradicts the materiality ruling in *Basic* 485 U.S. 224. Respondent Shapiro does not ever even quote that language; and Respondent Bassman, quotes the relevant language but then asserts that the language used by the Third Circuit did not really mean what it said.

Both Respondents devote most of their discussion to *Virginia Bankshares*. However, contrary to Respondents' arguments, Petitioners do not challenge here the proposition that directors and officers who speak on a material subject are bound to speak truthfully. Nor do Petitioners challenge the definition of materiality announced by this Court in *TSC Indus., Inc. v. Northway Inc.*, 426 U.S. 438, 449 (1976). What Petitioners do challenge is the Third Circuit's statement, which contradicts this Court's *Basic* decision, that any time a director or officer speaks, that statement is material and thus can form the basis of a securities fraud claim. *UJB*, 964 F.2d at 282. This position was rejected in *Basic*. "[M]ateriality depends on the significance the reasonable investor would place on the withheld or misrepresented information," *Basic*, 485 U.S. at 240, and is an issue distinct from the truth or the falsity of the statement (*id.* at 241). Nothing in *Virginia Bankshares* in any way overrules or retreats from this proposition.

In short, under *Basic*, determination of whether the statement was material must be based upon more than the mere fact that it was made.

Respectfully submitted,

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Dated: September 21, 1992

Petitioners' Appendix I

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NOT FOR PUBLICATION

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

V. Rachel Lerch, Plaintiff	:	
v.	:	Civil Action No. 90-3538 (Hon. Harold A. Ackerman)
Citizens First Bancorp., Inc. Defendant	:	OPINION
Harriette Roth, et. al. Plaintiff	:	
v.	:	
Richard G. Kelley, et. al., Defendant	:	

Ackerman, D.J.

This matter involves allegations of securities fraud against a corporation and its outside auditor, and a vigorous argument by the defendant corporation and auditor that they, as well as other financial institutions, are being scapegoated for the current economic decline in the country. Defendants' argument takes the form of a motion to dismiss the complaint for failure to state a claim upon which relief can be granted, and for failure to plead fraud with the particularity required under Federal Rule 9.

For the following reasons, the motion is denied.

I. Standard for Motion to dismiss

When assessing a motion to dismiss under Rule 12(b)(6), "the court must accept as true all factual allegations in the complaint and view them in a light most favorable to plaintiff." DP Enterprises, Inc. v. Bucks County Community College, 725 F.2d 943, 944 (3rd. Cir. 1984); Walck v. American Stock Exchange, Inc., 687 F.2d 779, 780 (3rd Cir. 1982). The court may dismiss the complaint

only if "it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." Conley v. Gibson, 355 U.S. 41, 45-56 (1957).

II. Background

Defendant Citizens First Bancorp, Inc. ("Citizens") is a financial corporation that conducts a general banking business through its subsidiary, Citizens First National Bank of New Jersey. Citizens' securities are registered with the Securities and Exchange Commission ("SEC") and its common and preferred stock are traded on the American Stock Exchange. Plaintiffs, who seek to represent a class of shareholders that invested in Citizens between December 1989 and August 1990[1], essentially allege that defendants fraudulently misrepresented Citizens' financial situation, causing plaintiffs to invest in the company and suffer serious financial loss.

The saga, and class period, began on December 20, 1989, when Richard Kelley, Citizens' Chairman of the Board, announced that Citizens' dividends on common stock wee [sic] increasing from $.60 per share to $.72 per share annually. Kelley assured potential shareholders that Citizens was experiencing a record year for profits. On January 17 1990, Citizens announced that it had achieved a net income of $9,459,000, or $.44 a share, for the fourth quarter of the 1989 fiscal year. For the full fiscal year, Citizens reported a net income of $37,190,000, or $1.73 per share. This reflected an 18.2% increase over the equivalent time period in 1988. Nonetheless, on February 1, 1990, Citizens announced a plan to repurchase 500,000 shares of its own common stock on the open market, informing shareholders that the market price of Citizens stock was undervalued.

On March 30, 1990, Citizens filed with the Securities and Exchange Commission its Form 10-K and Annual Report for fiscal year 1989. Citizens disclosed that for each quarter of 1989, the number of nonperforming loans issued by Citizens had increased from 2.35% to 3.60% of its total

1. Plaintiffs' motion for class certification is not addressed in this opinion.

outstanding loans. Still, Citizens announced that it had created provisions for loan losses of only $1,650,000 (an aggregate for the year of $6,600,000), a figure essentially unchanged from the previous year despite the increase of nonperforming loans. Citizens defended this decision by informing shareholders that "a substantial portion of these loans are collateralized by real estate, as well as by the personal guarantees of the principals." Citizens also informed shareholders of its internal procedures for setting the loan loss reserve[2]:

> The allowance for loan losses is generated through the charges to earnings. Loan losses (loans charged off net of recoveries) are charged against the allowance for loan losses. If, as a result of loans charged off or increases in the size or risk characteristics of the loan portfolio, the allowance is below the level considered by management to be adequate to absorb future loan losses, the provision for loan losses is increased to the level considered necessary to provide an adequate allowance.

Citizens went on to assure shareholders that "[a]s a result of the increase in nonperforming loans, it is possible that additional chargeoffs may occur in the future. However, management believes that the allowance for loan losses is sufficient to absorb these possible additional chargeoffs. . . . In the opinion of management, the allowance for loan losses is adequate to absorb both current and future losses."

The Annual Report for 1989 contained a Letter To Shareholders from Kelley and defendant Rodney T. Verblaauw, President and director of Citizens, detailing to investors the secure state of Citizens' loan loss reserves:

> **REAL ESTATE LOANS ARE MANAGEABLE**
>
> There has been a great deal of press coverage regarding nonperforming real estate loans in the nation and in New Jersey. At year-end, our nonperforming loans amounted to $77.7 million, up from $45.6 million at year-end 1988. Loan losses for 1989, net of recover-

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2. The practice or setting loan loss reserves is discussed below.

ies, were $5.3 million, compared with $2.4 million in net losses in 1988. Although we are obviously not insulated from the problem, this total is at a manageable level. Each problem loan has been identified , and a plan has been implemented to work toward an orderly reduction of the debt. We believe that there are adequate reserves in our loan loss allowance to cover all present and future problems.

Lest investors think Citizens could wind up being victims of the economic downturn, Kelley and Verblaauw also assured investors of Citizens' sound management procedures:

> We continue to evaluate our loan portfolio by using early warning signals to classify loans where signs point to deteriorating quality. All classified loans were previously identified, and no additions have been made by regulatory examinations or outside audit reviews. We are following our traditional conservative lending practices to minimize future risk. Almost all of the commercial properties we finance are owner occupied or substantially leased. Residential construction loans to builders are limited to two homes ahead of sale, and borrowers must have a strong net worth.

In the "Management's Discussion and Analysis of Financial Condition and Results of Operations", Citizens again detailed its internal control procedures:

> On a monthly basis, management reviews loans delinquent 30 days or more, nonaccrual loans, and other loans identified as needing additional review. In addition, management considers loans identified in the most recent examination by the Comptroller of the Currency and the external auditors. Loans or portions thereof that are determined to be uncollectible are either reserved for or charged off. Loans 90 days past due are placed on a nonaccrual basis unless they are secured and in the process of collection. The evaluation of loans in these categories takes into consideration the risk of the prospective loss presented by such loans and potential sources of repayment, including collateral security. An estimate of losses existing in the portfolio is also made with consideration given to

> historical data, negative trends in overall delinquencies, concentration of loans by industry, current and anticipated economic conditions that might result in increased delinquencies and new loan types as well as the area served and other relevant factors. . . . [N]onperforming classification does not mean nonearning, but rather, that the probability exists that the interest owed will not be received in ful [sic] and within the contractual term.

On March 19, 1990, Citizens filed with the SEC, and distributed to shareholders, a Proxy Statement that assured investors that on the recommendation of Citizens' internal Audit Committee, defendant accounting firm Coopers & Lybrand had been retained as independent certified accountants to audit Citizens' 1989 financial statements. In the 10-K form filed with the SEC, and in the Annual Report for 1989, Coopers represented to Citizens' shareholders and the SEC that:

> We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.
>
> In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Citizens First Bancorp, Inc. and Subsidiary at December 31, 1989 and 1988, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 1989, in conformity with generally accepted accounting principles.

On April 16, 1990 Citizens announced that it had achieved a net income of $6,530,000, or $.30 a share, for

the first quarter of 1990. This was down from $9,283,000, or $.43 a share for the similar period in 1989. This decline apparently was due to the fact that Citizens had increased the quarterly provision for loan losses from $1.65 million to $5 million for the first quarter of 1990, and was planning to make a similar provision for the second quarter. Nevertheless, defendants assured shareholders that the increased provisions reflected Citizens' philosophy of caution, sound management and fiscal conservatism. According to the PR Newswire, "Kelly stated that Citizens is a very conservative institution and has a philosophy of dealing with circumstances before they become a problem. The action taken today is a continuation of this philosophy."

In a Form 10-Q, filed with the SEC on May 14, 1990, Citizens continued to assure investors of the adequacy of its loan loss reserves. Particularly, the Form stated that "the nonperforming classification does not mean nonearning; but rather that the probability exists that the interest owed will not be received within the contractual term . . . . [A] substantial portion of these [nonperforming] loans are collateralized by real estate, as well as by the personal guarantees of the principals." The Form represented that "in management's opinion, the current provision for loan losses reflects the amount deemed appropriate to produce an allowance for loan losses adequate to meet the present and foreseeable risk characteristics of the loan portfolio."

On July 27, 1990, Citizens disclosed that it would report a loss of $34,488,000, or $1.47 a share, for the second quarter of 1990, due to its increase in loan loss reserves to $70 million. This provision was fourteen times greater than the provision for the first quarter of 1990, and forty-two times greater than the provision for each of the quarters of 1989. Subsequently, a director of Citizens disclosed that $20 million of the $70 million addition to reserves was needed because bank examiners had found that files documenting Citizens' loans lacked current appraisals and financial statements.

Citizens' second quarter 10-Q reported an increase in nonperforming assets from $77,085,000 at the end of 1989 to $192,075,000 at June 30, 1990. For the first time, this 10-Q reflected the classification of non-performing assets,

consisting of nonaccrual loans, troubled debt restructuring, and foreclosed real estate. Until this time, Citizens had not included "foreclosed real estate" as an aspect of nonperforming loans and had no classification of "nonperforming assets". Of the increase, $101,602,000 was due to foreclosed real estate, though Citizens stated on the form that foreclosed real estate had been just $713,000 on December 31, 1989.

On August 28, 1990, Citizens reported that Robert Iamuzzo, a Coopers auditor who had acted in a secondary review capacity on Citizens's 1989 audit, was in default to Citizens on a substantial amount in loans issued him by Citizens.

During the time Citizens was portraying itself as a profitable firm, different than the rest, Citizens' common stock reached over $12 per share. On July 18, 1990, the end of the Class period, Citizens stock had fallen by more than 44%, to $7 per share.

On September 6, 1990, plaintiffs filed this complaint, alleging that defendants—consisting of Citizens, Coopers, and several named officers of Citizens and Coopers—intentionally committed a fraud that resulted in the artificial inflation of the price of Citizens' common stock during the Class period.[3] Specifically plaintiffs alleged that the price remained inflated because Citizens failed to provide sufficient reserves to cover loan losses. This failure to provide adequate loan loss reserves allegedly enabled Citizens to represent that its profits were increasing, and hence attract investors. Plaintiffs also contend that Citizens misrepresented the adequacy of its internal control procedures, its lending policy, and the secured nature of nonperforming loans. Plaintiffs further contend that defendant Coopers committed fraud by misrepresenting that its 1989 audit of Citizens complied with generally accepted accounting principles.

Count I of plaintiffs' complaint alleges that Citizens and Coopers perpetrated securities fraud, in violation of federal laws. Count II alleges that the individually named

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3. Originally, this cause of action involved two complaints. They were consolidated, however, on January 9, 1991.

defendants are also liable to plaintiffs as "controlling persons" under Section 20(a) of the Exchange Act.[4] Counts III and IV allege that defendants' actions constituted negligent misrepresentation and fraud under New Jersey common law.

Citizens and its representative named in the suit (the "Citizens defendants") originally moved to dismiss two particular clauses of the complaint, arguing that those clauses alleged unactionable mismanagement rather than fraud. Coopers, though, moved for a complete dismissal of the complaint, for failure to plead fraud with particularity and for alleging mismanagement rather than fraud. In February, 1992, however, Citizens defendant Kelley, later joined by all Citizens and Coopers defendants, made a supplemental motion to dismiss the entire complaint. In this opinion, I address the adequacy of the complaint with respect to all these arguments.

III. Discussion

Plaintiffs' cause of action involves two separate categories of claims: (1) Securities fraud against Citizens and Coopers, under Section 10(b) of the Exchange Act; and (2) common law claims under New Jersey law. The Citizens defendants contest only the federal claims; Coopers contests both the federal and state claims.

A. Federal securities law

Because the issues raised in this case have been the focus of much discussion in federal courts, a word about the purpose of the securities fraud laws and the courts' interpretations of them is in order.

Under Section 10(b) of the Exchange Act of 1934, and the Securities and Exchange Commission's Rule 10b-5 (the "Exchange Act"), misrepresenting or omitting material information in connection with the purchase or sale of securities is unlawful. When claiming a violation of these sections, a plaintiff not only has to satisfy Fed.R.Civ.P.

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4. This claim is not before the court; the moving defendants do not challenge the allegation that the named individuals are controlling members under Section 20(a).

12(b)(6)'s mandate to state a claim upon which relief can be granted, a plaintiff also must satisfy Federal Rule of Procedure 9(b), which provides a minimum standard for pleading fraud. Rule 9(b) states, in relevent part:

> In all averments of fraud . . . the circumstances constituting fraud . . . shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally.

Over the past several years, allegations of securities fraud against financial organizations have increased with the decline in the American economy. As such cases have increased in number, courts across the country have struggled over the correct application of the federal rules on pleading to the Exchange Act. Underlying this problem are two apparently conflicting policies. On the one hand, firms must be protected against claims arising only from hindsight and from a desire to scapegoat certain institutions for the economic downturn of recent years. Describing the complaint in another case, the Seventh Circuit summed up this policy:

> The story in this complaint is familiar in securities litigation. At one time the firm bathes itself in a favorable light. Later the firm discloses that things are less rosy. The plaintiff contends that the difference must be attributable to fraud.

DiLeo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir.), cert denied, 111 S.Ct. 347 (1990).

But on the other hand, it is increasingly possible for sophisticated companies to shield their fraudulent actions by concealing documents, cleverly wording public releases and hiding behind the rocks of "puffery" and "ordinary selling". As the Third Circuit has observed:

> Particularly in cass [sic] of corporate fraud, plaintiffs cannot be expected to have personal knowledge of the details of corporate internal affairs.

In re Craftmatic Securities Litigation v. Kraftsow, 890 F.2d 628, 645 (1989).

For its part, amid several cases, the Third Circuit has tried to strike a balance between the competing policies. It has cautioned that "focusing exclusively on [Rule 9(b)'s]

particularity language is 'too narrow an approach and fails to take account of the general simplicity and flexibility contemplated by the rules.'" Seville Industries Machinery v. Southmost Machinery, 742 F.2d 786, 791 (3rd Cir. 1984), cert. denied, 469 U.S. 1211 (1985) (citations omitted)). In Seville industries, the Court of Appeals further noted that:

> Rule 9(b) requires plaintiffs to plead with particularity the "circumstances" of the alleged fraud in order to place the defendants on notice of the precise misconduct with which they are charged, and to safeguard defendants against spurious charges of immoral and fraudulent behavior. It is certainly true that allegations of "date, place or time" fulfill these functions, but nothing in the rule requires these means of injecting precision and some measure of substantiation into their allegations of fraud.

Seville, 742 F.2d at 791; accord Saporito v. Combustion Engineering, Inc., 843 F.2d 666, 674 (3rd Cir. 1988), vacated on other grounds, 109 S.Ct. 1306 (1989). The point of this standard is to assure that the allegations are sufficient to put the defendants on notice of the violations that each of them is alleged to have committed.[5]

In a more recent case, however, the Court of Appeals amended somewhat this liberal pleading rule, and held that a plaintiff must show that its case implicates the concern that prior to discovery, the defendants are in a position to cover up fraud. The Third Circuit held in that case that when pleading fraud, a plaintiff "must accompany such an allegation with a statement of facts upon which their allegation is based." Shapiro v. UJB Financial Corp., No. 91-5153, slip op. at 31 (May 20, 1992). And while this part of

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5. Defendants argue that courts should not let allegations of fraud to be pleaded upon information and belief. The Third Circuit, however, recently contradicted this contention, stating that "where the facts are in the exclusive possession of the adversary, courts should permit the pleader to allege the facts on information and belief, provided a statement of the facts upon which the belief is founded is proferred." Shapiro at 31.

the rule is read liberally—for example, plaintiffs complaining against corporate defendants are permitted to make accusations founded only upon information and belief—a complaint "must delineate at least the nature and scope of plaintiffs' effort to obtain, before the filing of the complaint, the information needed to plead with particularity," Shapiro at 31, and a plaintiff must allege "defendants' exclusive control over the information defendants require." Shapiro at 12.

Thus, in analyzing any allegation of fraud, a court first must assess whether the claim, if true, would violate the Exchange Act, and, if so, determine, in light of the policies outlined above, whether the claim is pleaded with the requisite particularity under the rule. I will assess the claims against Citizens and Coopers separately.

1. Citizens

a. Rule 12(b)

To state a claim of securities fraud under the Exchange Act, a plaintiff must plead: (1) a false representation of (2) a material, (3) fact; (4) the defendant's knowledge of its falsity and his intention that the plaintiff rely on it; (5) the plaintiff's reasonable reliance on the representation, and (6) the plaintiff's resulting loss. Lewis v. Chrysler Corp., 949 F.2d 644, 649 (3d Cir. 1991). Citizens alleges that plaintiffs do not state a claim of fraud under the Exchange act, because the plaintiffs' complaint is based solely on "fraud by hindsight" and its allegations involve only corporate mismanagement and wrongheaded predictions about the future. Plaintiffs respond by claiming that under the law in this Circuit, they have alleged a claim of securities fraud.

The essence of plaintiffs' complaint against Citizens is that Citizens and several of its officers deliberately understated loan loss reserves in order to artificially inflate Citizens profits, and hence the price of Citizens stock. Because the complaint focuses on loan loss reserves, I begin the analysis of plaintiffs' complaint with a discussion of the practice of setting loan losses.

A loan loss reserve is a

> statement of condition, or balance sheet, account set up by a bank based on its expectations about future loan losses. As losses occur, they are charged against this reserve. That is, the loan account is credited and the reserve account is debited. The reserve is established by a debit to an expense account called the loan loss provision, with a corresponding credit to the loan loss reserve.

Shapiro at 20 (quoting American Bankers Association, Banking Terminology 215 (1989). Banks use various methods to evaluate and set loan loss reserves. All methods, however, revolve around specific analyses of the past and present status of loans. Economic judgments made in setting loan loss reserves can be proven right or wrong only at some future date. Shapiro, at 21. Citing C. Edward McConnell, Loan Loss Reserve Management and Unwise Lending Practices, in Bank Credit 354, 354-55 (Herbert V. Prochnow, ed., 1981). The setting of loan loss reserves, however, is intimately related to the bank's analysis of the state of its existing loans, particularly its nonperforming loans. And the setting of loan loss reserves, while involving some economic judgment and prediction, may be judged as involving either sound or risky business management judgment.

Plaintiffs allege that Citizens misrepresented the necessary amount of loan loss reserves and did not set loan policy in keeping with its professed management style.

The first question under the standard for stating a claim is whether plaintiffs allege misrepresentations of facts. Many of plaintiffs' allegations clearly involve misrepresentations of fact. These include allegations that Citizens' knew that its set-aside for loan loss reserves were inadequate to cover its expected amount of loan losses; that contrary to Citizens' nonperforming loans were ot [sic] adequately collateralized and/or guaranteed; and that Citizens knew that the outside accounting firm conducting the 1989 audit of Citizens utilized an auditor with debts outstanding to Citizens.

While these claims clearly allege misrepresentations of fact, alleged misstatements or omissions about loan loss

reserves need not be so specific to constitute facts. Rather, in a recent case, the Supreme Court held that a firm's statements of its reasons for actions, opinions or beliefs—such as that a bank's lending practices are "conservative" or that its loan loss reserves are "adequate"—also may be factual. Writing for the Court, Justice Souter said that such statements are "factual in two senses: as statements that the directors do act for the reasons given or hold the belief stated and as statements about the subject matter of the reasons or belief expressed." Virginia Bankshares, Inc. v. Sandbert, 111 S.Ct. 2749, 2758 (1991).[6] If a defendant financial institution affirmatively characterizes the management practices it utilized to determine the amount of loan loss reserves, "the securities laws are clearly implicated if [defendant] nevertheless intentionally or recklessly omits certain facts contradicting these representations." Shapiro at 22.

In this case, plaintiffs allege that defendants represented to its shareholders that it followed the following management practices:

-- Citizens identified problem loans and implemented plans to work towards an orderly reduction of debt;

-- Citizens was a conservative institution with a philosophy of dealing with circumstances before the [sic] became a problem;

-- Citizens evaluated the loan portfolio by using early warning signals to classify loans that seemed to be deteriorating;

-- Citizens' Audit Committee oversawthe [sic] scope, easonableness and adequacy of its internal accounting controls; oversaw the continuous examination into Citizens' affairs; reviewed and reported the results of internal audits with Citizens' Board of Directors; and reviewed and cri-

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6. Although the Supreme Court held only that statements of opinion by directors can be material factual statements, the Third Circuit has interpreted this materiality to apply to managers, as well, since "[a] manager's knowledge and expertise regarding the day-to-day operation of his company generally exceeds that of a director, and the reasonable investor is aware of this fact." Shapiro, slip op. at 23.

tiqued all reports from regulatory authorities issued as a result of their examiantions [sic] of Citizens' activities;

Plaintiffs then allege that defendants intentionally omitted facts contradicting defendants' representations that they used these management practices. The gist of plaintiffs' complaint is that defendants knew that these management practices were not being followed; rather, defendants:

-- did not identify each problem loan and act on it;

-- did not invest conservatively, and identify problems in advance;

-- did not have a tight internal control system that used early warning signals to keep track of loans;

-- did not keep track of its internal control system through citizens' Audit Committee;

With these statements of Citizens' ostensible management and control practices, and plaintiffs' specific allegations that they were not complied with, under Shapiro and Virginia Bankshares, plaintiffs also have alleged the misrepresentations of facts. Thus, plaintiffs' allegations of misrepresentations or omissions of fact correctly involve actual empirical statements as well as statements of Citizens' internal control procedures and management practices.

The next questions are whether such misrepresentations involve material facts and whether such facts reasonably were relied upon. In a recent case, the Third Circuit held that:

> Materiality is a mixed question of law and fact, and the delicate assessments of the inferences a reasonable shareholder would draw from a given set of facts are peculiarly for the trier of fact. Only if the alleged misrepresentations or omissions are so obviously unimportant to an investor that reasonable minds cannot differ on the question of materiality is it appropriate for the district court to rule that the allegations are inactionable as a matter of law.

Shapiro at 19, n. 11 (citations omitted). In that case, the Court also had occasion to comment on the materiality of misrepresentations or omissions regarding loan loss reserves in particular. The Court of Appeals pointed out that

"[t]here is nothing unique about representations and omissions regarding loan loss reserves that removes them from the purview of the antifraud provisions of the federal securities laws." Shapiro at 21. Rather, "a reasonable investor would be influenced significantly by knowledge that a bank knowingly or recklessly has hidden its true financial status by deliberately misstating its level of non-performing loans, failing to provide adequate reserves and indulging its problem loan customers." Shapiro at 21. Thus, misleading or fraudulent statements about loan loss reserves are misrepresentations of material facts reasonably relied upon by potential invstors, and "can be the basis for liability under Rule 10b-5." Id. at 22.

The next step in the analysis asks whether plaintiffs have alleged that defendants knowingly misrepresented or omitted material facts. In this regard, Rule 9(b) clearly provides that "instant [sic], knowledge, and other conditions of mind of a person may be averred generally." This provision has been applied to allegations concerning a defendant's state of mind in a fraud claim. CFTC v. American Metal Exchange, 693 F.Supp. at 168, 191 (D.N.J. 1988); Kronfeld v. First Jersey Nat. Bank, 638 F.Supp. 1454, 1465 (D.N.J. 1986). This standard is satisfied where plaintiff "aileges generally that defendants had actual knowledge of the materially false and misleading statements and omissions . . . or acted with reckless disregard for the truth." Kronfeld at 1465. Plaintiffs satisfy this test.

Finally, the test asks whether plaintiffs have alleged that they suffered harm as a result on reliance on defendants' fraud. Plaintiffs have alleged that they sustained significant losses because of reliance upon Citizens' representations detailed above, and that Citizens intended potential investors to rely on its misrepresentations. Thus, they pass this prong of the test.

Consequently, plaintiffs are permitted to try to prove that defendants knowingly misrepresented the material facts about its internal control and management practices, resulting in both understatements of its loan loss reserves and the

artificial inflation of the price of Citizens' stock.[7]

However, "mere failure to provide adequate reserves [however] does not implicate the concerns of the federal securities laws and is not normally actionable." Id. at 21. Plaintiffs may not, then, attempt to prove that defendants simply failed to provide adequate loan loss reserves. Such allegations involve mismanagement rather than fraud, and are not actionable under the Exchange Act. Any allegation of failure to provide adequate loan loss reserves must be tied to an allegation that defendants fraudulently failed to comply with the banking practices they assured investors they were following.

b. Rule 9(b)

Having determined that plaintiffs have stated a claim of fraud under the Exchange Act, I must determine whether their complaints comply with FederalRule of Civil Procedure 9(b).

As outlined above, the Third Circuit has adopted a liberal approach to Rule 9(b), tempered by certain specific requirements. Determining the adequacy of plaintiffs' fraud complaint involves a three-step analysis: First, do plaintiffs state facts specifically enough? In situations like the instant case, however, the Third Circuit has recognized that specific information necessary to prove fraud may be within the defendant corporation's control. In such circumstances, plaintiffs may satisfy te [sic] pleading rule by stating in the complaint: 1) how plaintiffs attempted to gain the necessary information to plead fraud more particularly; and 2) that the defendants have exclusive control over necessary information.

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7. As a corollary, plaintiffs may also attempt to prove that defendants' misrepresentations resulted in false statements of defendants' profits, and that defendants actions such as purchasing its own common stock because it felt the market was not reflecting the real price of Citizens stock violated its representations of its conservative management practices. As wit [sic] the loan loss claims, though, plaintiffs may not attempt to prove simply that defendants' projedtions [sic] about the future proved wrong.

Specificity of facts

In Shapiro, the Third Circuit held that to satisfy Rule 9, a plaintiff "must accompany . . . an allegation [of fraud] with a statement of facts upon which their allegatioan [sic] is based." Shapiro at 31. This statement must be read in the contet [sic] of Shapiro's generally liberal approach to securities fraud cases. In this case, plaintiffs have offered a number of statements of facts upon which their allegations are based. Most importantly, plaintiffs primarily draw the inference of fraud from Citizens' sudden and dramatic escalation of loan loss reserves after repeated assurances that loan policy is under control. In making such allegations, this court has held in a prior case that Rule 9(b) is satisfied when the plaintiff (1) quoted verbatim from the alleged misrepresentations; (2) explained the context in which the representations were made, and (3) described the various defendants involved in the investment program as well as their roles in the scheme. Id. at 190.[8] CFTC v. American Metal Exchange, 693 F.Supp. 168, 190 (D.N.J. 1988).

In this case, the plaintiff has met this burden. First, plaintiff has quoted extensively from alleged misrepresentations made by the defendant, including Annual Reports, press releases, filing with the SEC and press reports. The complaint also explains the context in which the representations were made. The complaint presents the following context, which could lead one to believe that fraud has taken place: Citizens' refusal to expand loan loss reserves, the assurances of the optimistic state of Citizens, the sudden dramatic escalations of loan loss reserves; the assurances

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8. Defendants assert in a recent letter to the court that this standard is in conflict with the Third Circuit's recent decision in Shapiro because it does not require a plaintiff to plead facts with enough specificity. Defendants misunderstand the mechanics of pleading fraud. This Rule 9(b) inquiry only takes place after the court has determined that the plaintiff alleged the defendants' knowing misrepresentatioan or omission of a material fact, reasonably relied upon by plaintiffs, that caused plaintiffs harm. The Rule 9(b) specificity requirement requires only that these facts are pleaded with the degree of specificity that enables defendants to respond.

about real estate foreclosure that turned out to be false, the assurances about Citizens' conservatism and risk-averse policies that seemed to contradict Citizens' practices. Finally, the complaint described the various defendants' actions and explains their roles in the allegedly fraudulent scheme.[9]

In other words, plaintiff's allegations, while not brimming with factual detail, are clear and specific enough to permit the defendants to file responsive pleadings, which they in fact did.

Even so, though, I recognize that the allegations in this complaint may not have survived Rule 9(b) scrutiny if the situation did not involve a corporate defendant with probable exclusive control over the necessary material. Thus, I turn to the other prongs of the analysis.

Plaintiffs' attempt to delineate information

I find that the complaint satisfies the requirement that plaintiffs detail their efforts to obtain the necessary information to plead with specificity. It is self-evident from the complaint that the plaintiffs reasonably examined the relevant public records. They quote from Securities and Exchange Commission filings, press releases, annual reports, and other communications between the corporation and its shareholders. It is difficult to imagine what more they could have done at this stage in the litigation.

Plaintiffs' allegation of defendants' exclusive control

Shapiro also stated that a complaint must specifically allege that defendants have exclusive control of information plaintiffs require. Shapiro at 30. The Third Circuit itself,

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9. Specifically, Richard G. Kelley was the Chairman and chief Executive Officer of Citizens. He issued many of the statements representing Citizens' management practices. Rodney T. Verblaauw, President and director of Citizens, also participated in some of Mr. Kelley's statements. Jack M. Blackin was the principle financial officer and principal accounting officer for Citizens, and hence responsible in some way for establishment of loan loss reserves. John J. Cahill, Walter W. Weber, Jr. and Daniel W.Dwyer were directors of Citizens and members of its Audit Committee, which plaintiffs allege intentionally failed to comply with Citizens' alleged stringent internal control procedures.

though, referred to such provisions as "boilerplate," and I find that the nature of the complaint, the situatiaons of the parties make it obvious that only after discovery will plaintiffs have access to information that could truly substantiate their allegations.[10]

Plaintiffs' complaint, therefore, is written with sufficient particularity to withstand defendants motion to dismiss.

2. Coopers & Lybrand Claim

Along with supporting the general arguments above, defendant Coopers & Lybrand (Coopers) also moves to dismiss the complaint specifically against it. It claims that plaintiff's "conclusory allegations" simply do not suffice to state a claim of fraud under Rule 9(b). I disagree.

Plaintiffs make two allegations against Coopers: (1) Coopers engaged in primary fraud; (2) Coopers aided and abetted Citizens in the commission of fraud. I address these in turn.

a. Primary Fraud

1. Rule 12(b)

As detailed above, a party may allege fraud by establishing (1) a false representation of (2) a material, (3) fact; (4) the defendant's knowledge of its falsity and his intention that the plaintiff rely on it; (5) the plaintiff's reasonable reliance on the representation, and (6) the plaintiff's resulting loss. As detailed above, plaintiffs can meet this burden

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10. Again, defendants argue that Shapiro imposes a more stringent standard. And again, defendants mistake the trees for the forest. To dismiss a complaint simply because it did not contain the standard clauses required under Shapiro would be to ignore the thrust of the opinion, which is to provide relaxed pleading requirements. The Shapiro Court simply intended to ensure that complaints were made in good faith and after reasonable attempts to plead specifically. If it is clear from the fact of the complaint that plaintiffs used avilable attempts to gain specific information, and if the complaint makes it obvious that the bulk of materials evidencing fraud would be in defendants' hands, the Third Circuit's test is satisfied.

by alleging a firm's general statements of its management practices and alleging that the firm intentionally failed to comply with these practices. In this case, Coopers' management practices were described in its filing with the Securities and Exchange Commission of 10-K in 1989. In that form, Coopers described the auditing practices it used to assess Citizens' finances. It certified that:

> We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.
>
> In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Citizens First Bancorp, Inc. and Subsidiary at December 31, 1989 and 1988, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 1989, in conformity with generally accepted accounting principles.

Plaintiffs allegations regarding this statement meet the requisite standard:

First, such a statement constitutes representations of Coopers' professional practices, and hence constitute representations of material fact.

Second, plaintiffs allege that the above statement constituted misrepresentation and omission. Specifically, plaintiffs allege that Coopers failed to conform to these representations, in the following manners:

- Generally accepted accounting standards require that the auditor be independent. In fact, a Coopers auditor working in a secondary review capacity had owed outstanding debts to Citizens. It seems that this allegation fuels

plaintiffs' contention that the Citizens defendants and Coopers engaged in a joint attempt to fraudulently inflate the price of Citizens' stock.

-- Generally accepted accounting standards require that an auditor exercise "due professional care." Plaintiffs allege that Coopers intentionally failed to comply with this standard, by deliberately misleading potential investors into thinking that Citizens' financial state was sound. Specifically, plaintiffs contend that Coopers deliberately overlooked the fact that Citizens' loan files did not contain current appraisals and financial statements, resulting in the understatement of Citizens' loan loss reserves by $20 million.

- Coopers intentionally failed to properly study and evaluate Citizens' internal control system;

- Coopers intentionally did not obtain sufficient competent evidential matter to afford a reasonable basis for its statements in abut [sic] Citizens' 1989 financial statements.

Third, "the alleged misrepresentations or omissions are [not] so obviously unimportant to an investor that reasonable minds cannot differ on the question of materiality [and] it is [inappropriate] for the . . . court to rule that the allegations are inacitnable [sic] as a mater [sic] of law." Shapiro at 19, n. 11. Thus, they involve misrepresentation or omission of material facts.

Fourth, just as it is reasonable for a potential investor to rely on a bank's statement of its management practices, it is reasonable for a potential investor to rely on an auditor's statement of its exercise of care and its independence in the performance of an audit.[11]

Fifth, plaintiffs have alleged scienter. As noted above, this requirement is satisfied where plaintiff "alleges generally that defendants had actual knowledge of the materially false and misleading statements and omissions . . . or acted with reckless disregard for the truth,." Kronfeld, 638

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11. Defendant correctly points out that plaintiffs have not explicitly alleged reliance on Coopers' audit. To grant defendants' motion on this ground, though, would represent pure formalism at the expense of efficiency.

F.Supp. at 1465. Plaintiffs have alleged scienter as well as Coopers' intention that potential shareholders rely on their representations.

Finally, plaintiffs have alleged financial loss.

Thus, plaintiffs have alleged a securities fraud case against Coopers.

2. Rule 9(b)

I now assess whether their pleadings satisfy Rule 9(b). As with Citizens, plaintiffs first must plead facts with sufficient detail. And as with Citizens, plaintiffs satisfy this standard by (1) quoting verbatim from the alleged misrepresentations; (2) explaining the context in which the representations were made, and (3) describing the varius defendants involved in the investment program as well as their roles in the scheme.

In this case, plaintiffs meet this standard by quoting Cooper's own language in Citizens' 1989 Annual Report; explaining the contest [sic] of Coopers sending as one of its auditors of Citizens an individual in default of substantial money to Citizens; and describing this defendant's alleged role in the audit and in the scheme.[12]

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12. Coopers argues that plaintiffs fail to meet 9(b)'s particularity requirements in that plaintifffs have not identified which accounting practices were violated, and how these practices were departed from. I disagree.

First of all, it is undisputed that Robert Iamuzzo, a Coopers auditor working in a secondary capacity on Citizens' audit, was indebted to Citizens for millions of dollars. If Coopers knew of this indebtedness, thenit [sic] clearly did violate the requirement that an auditor be independent. Moreover, once such a suspicious scenario is alleged, it is perfrectly [sic] reasonable to inquire, through discovery, about the extent of the relationship between Citizens and Coopers, particularly between Citizens and any particular employees of Coopers.

Second, plaintiffs are quite specific in their allegation that by failing to ascertain that Citizens' files lacked current appraisals and financial statements, Coopers intentionally failed to exercise due professional care. More importantly, plaintiffs allege the particular finan-

(continued...)

Aiding and Abetting

Defendants next contend that plaintiffs fail to state a claim for aiding and abetting under the securities laws. To establish a securities claim of aiding and abetting, a plaintiff must establish:

> (1) an underlying securities violation by a primary actor, (2) the party charged with aiding and abetting knew of the fraudulent conduct, and (3) the party charged substantially participated in the perpetration of the fraud.

Midatlantic, 758 F.Supp. at 237 (citing Walck v. American Stock Exchange, Inc., 687 F.2d 778, 791 (3d Cir. 1982) and Landy v. FDIC, 486 F.2d 139,162-63 (3d Cir. 1973)).

As discussed previously, plaintiff has adequately alleged a primary securities fraud violation by Citizens. Thus, the first element is satisfied. The second element refers to the scienter issue. Again, scienter can be pleaded generally, so plaintiffs have satisfied this requirement. The third element is satisfied because plaintiff alleges that Coopers knowingly certified a fraudulent financial statement.

Thus, plaintiffs have stated a claim of securities fraud through aiding and abetting against Coopers.

I now turn to the state law claims.

C. State Law Claims

The Citizens do not raise any separatea [sic] arguments for why the stat [sic] elaw claims should be dismissed. Coopers, however, does. Since I have determined that the federal claims should not be dismissed, Coopers' argument that there is no pendent jurisdiction over the state claims is simply wrong.

Coopers further argues taht [sic] plaintiffs' state law

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12. (...continued)
cial statement that was allegedly fraudulently made, and the particular misrepresentation that resulted from this. It is difficult to imagine what more plaintiffs can allege at this stage of the litigation.

claim of fraud should be dismissed for failure to specifically allege reliance on the Coopers audit; and plaintiffs' state law claim of negligent misrepresentation should be dismissed because public investors in the marketplace do not have standing to assert such a claim. I address these in turn.

1. Fraud

Coopers is correctthat [sic] plaintiffs do not allege specific reliance on the Coopers 1989 annual financial statements which Coopers audited. The whole tenor of the complaint, however, clearly implies that plaintiffs relied on the assurances in the financial statements. While I could dismiss this portion of the complaint without prejudice, it is wasteful and inefficient to engage in that formalistic practice, particularly when plaintiffs have stated that they are willing to amend the complaint to state specific reliance.

2. Negligent Misrepresentation

Coopers finally contends that under Rosenblum v. Adler, 93 N.J. 324 (1983), public investors in the marketplace do not have standing to sue under a common law negligent misrepresentation theory.

I disagree. As interpreted by the Third Circuit:

> Rosenblum takes an expansive view of the range of permissible plaintiffs in a negligent misrepresentation action. It explicitly rejects the majority view that the plaintiff must be in privity, and adopts the more inclusive "reasonably foreseeable plaintiff" rule.

In the wake of such statements in Rosenblum, the Court of Appeals explicitly held that the state court decision did not limit foreseeable plaintiffs to those who invest for a "business purpose."

> There is no dispute here that the average investor was a reasonably foreseeable recipient of defendants' statements . . . . Moreover, the court looked to the expansive liability under the federal securities laws as a model for New Jersey law . . . Therefore, it is not accurate to say that Rosenblum's "business purpose" requirement limits the cause of action to those who make "significant" investors.

Shapiro at 42.

Thus, I decline to dismiss plaintiffs state law complaints on either of the grounds offered by Coopers.

CONCLUSION

For the reasons detailed above, defendants' motions to dismiss the complaint are denied in their entirety.